BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

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| In the Matter of the<br>Membership Continuance Application of | DECISION |
| Member Firm | Application No. 20060058633<br>Dated: July [ ], 2007 |

**NASD's Department of Member Regulation granted, subject to restrictions, the application of a member firm to make a material change in its business operations. Member Firm appealed the restrictions. Held, Member Regulation's findings are affirmed. Restrictions are affirmed in part and modified in part. Proceeding is remanded to permit the Member Firm to file an amended application.**

## Appearances

For Member Firm: Applicant Attorney, Law Firm A

For the Department of Member Regulation: Attorney 1, Department of Enforcement; Attorney 2, Department of Member Regulation

## Decision

Pursuant to Membership and Registration Rule 1015(a), the Member Firm ("the Member Firm") appeals from a December [ ], 2006 decision of the Department of Member Regulation ("Member Regulation") granting, subject to certain restrictions, the Member Firm's application to make a material change in its business operations. After conducting a hearing and reviewing the record, we affirm Member Regulation's findings that the Member Firm has failed to demonstrate that it would satisfy the standards in Membership and Registration Rule 1014(a)(3) and (13) if its application were to be approved in full. We affirm in part and modify in part the restrictions imposed by Member Regulation. We remand the proceeding to permit the Member Firm to file an amended application that would be processed on an expedited basis, consistent with the directives in this decision.

### I. Background

#### A. Member Firm

The Member Firm, a State 1 corporation with its main office in City 1, State 1, is an NASD member firm. Prior to this application, the Member Firm was approved to conduct two business lines: (1) underwriter or selling group participant; and (2) private placements of securities. During the pendency of the application, the Member Firm operated three registered

offices: one in City 2, State 2 ("the City 2 office"), one in City 1, State 1 ("the City 1 office"), and one in City 3, State 3 ("the City 3 office"). It also operated one unregistered office in City 2. As of June [ ], 2006, the Member Firm employed seven registered persons.

B. Firm A ("Firm A")

Firm A is listed in the Member Firm's Uniform Application for Broker-Dealer Registration ("Form BD") as an owner of 75% or more of the Member Firm. The Member Firm represented that Firm A's funds come only from capital contributions, and that its only business is as the parent of the Member Firm.

C. Persons Registered With the Member Firm

The Chairman ("Chairman") is the Member Firm's chairman and primary indirect owner, owning a 50 to 75 percent interest in Firm A. The Member Firm's business plan states that the Chairman has been in the securities industry for more than 39 years. The Chairman has been associated with the Member Firm since July 1997 and is registered as a general securities principal and a general securities representative. The Chairman is the supervisor of the City 1 office.

The chief executive officer of the Member Firm ("CEO") entered the securities industry in 1985 or 1986. Between 1987 and October 2005, the CEO worked for several broker-dealers in various management positions. The CEO has been associated with the Member Firm since October 2005 and is registered as a general securities representative, a general securities principal, and a financial and operations principal ("FINOP"). The CEO is the supervisor of the Member Firm's City 2 office.

The president ("president") has served as president of the Member Firm since January 2004. The president also is an indirect owner of the Member Firm.

Financial and Operations Principal A ("FINOP A") has been associated with the Member Firm since September 2004. He is registered with the Member Firm as a FINOP. FINOP A entered the securities industry in 1994. As of the date of the appeal hearing, FINOP A was registered as a FINOP with 11 broker-dealers, including the Member Firm.

The Supervisor ("Supervisor") is the supervisor at the Member Firm's City 3 office. The Supervisor has been associated with the Member Firm since May 2004. The Supervisor is registered with the Member Firm as a general securities representative and a general securities principal. The Member Firm's Central Registration Depository ("CRD"®) records state that the Supervisor pays all expenses for the City 3 office.

D. Other Relevant Persons

1. Firm B

Firm B ("Firm B") is a broker-dealer registered with NASD. Firm B is owned by Firm C ("Firm C"), a State 1 corporation. Firm C is owned by Firm D ("Firm D"), a company with the same corporate name as Firm C. The CEO of the Member Firm served as president of both Firm B and Firm D until August [ ], 2005.

2. Employee A

Employee A ("Employee A") became associated with Firm B in October 2003, and served as its president from October 2005 until July [ ] 2006.

3. Firm E

The Member Firm's CRD records indicate that associated persons at the Member Firm's City 3 office conduct other investment-related business activities under the name Firm E ("Firm E"). The CEO testified that Firm E is in the business of "raising capital for private and public companies, [and] merger and acquisition advisement and consulting." The Supervisor is the managing director of Firm E.

4. Individual A

Individual A ("Individual A") is a business partner of the Supervisor's at Firm E. As explained more below, questions arose during this application concerning Individual A's possible relationship to the Member Firm.

E. The Member Firm's Membership Continuance Application and Member Regulation's Decision

On July [ ], 2006, the Member Firm applied for approval of material changes in business activities, pursuant to Membership and Registration Rule 1017(a).[1] Specifically, the Member

[1] On June [ ], 2006, Member Regulation rejected as "not substantially complete" an earlier application filed by the Member Firm.

Firm requested approval: (1) to engage in several additional business activities,[2] (2) to employ 75 representatives; and (3) to operate 15 branch offices.[3]

After reviewing the Member Firm's application and making a series of requests for additional information, on December [ ], 2006, Member Regulation granted the Member Firm's application but imposed restrictions. Member Regulation began its analysis by noting that there was a rebuttable presumption that the Member Firm's application should be denied.[4] Member Regulation made reference to three of the seven events that triggered the rebuttable presumption of denial in this application:

- The Member Firm's 2004 Fine and Censure. On August [ ], 2004, an NASD Hearing Panel issued a decision finding that the Member Firm, acting through FINOP B ("FINOP B"), its FINOP at the time: (1) filed a late annual audit report; (2) filed a materially inaccurate FOCUS report; and (3) maintained books and records with inaccurate net capital computations, in violation of Securities Exchange Act of 1934 ("Exchange Act") Rules 17a-3 and 17a-5, and NASD Conduct Rule 2110. The Hearing Panel fined the Member Firm $3,000 for filing a late annual report.

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[2] The Member Firm requested approval to engage in the following activities: (i) broker or dealer selling corporate debt securities; (ii) broker or dealer retailing corporate equity securities over-the-counter; (iii) mutual fund retailer; (iv) non-exchange member arranging for transactions in listed securities by exchange member; (v) put and call broker or dealer or option writer; and (vi) broker or dealer selling tax shelters of limited partnerships in primary distributions.

[3] Membership and Registration Rule 1017(a)(5) required the Member Firm to file an application for approval of these activities because they would amount to a "material change in business operations." *See* Membership and Registration Rule 1011(i) (defining "material change in business operations" as including, but not limited to, "removing or modifying a membership agreement restriction"); Membership and Registration IM-1011-1 (instructing firms to contact their district office to see whether a business expansion exceeding the "safe harbors" requires a Rule 1017(a) application).

[4] Membership and Registration Rule 1017(g)(1) provides that if "the Applicant or its Associated Persons are the subject of any of the events set forth in [Membership and Registration] Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied." Among the events listed in Rule 1014(a)(3) are, in pertinent part, whether: "(A) a . . . self-regulatory organization has taken permanent or temporary adverse action with respect to a registration . . . determination regarding the Applicant . . .; [or] (C) an Applicant or Associated Person is the subject of a[n] . . . adjudicated[ ] or settled regulatory action or investigation by . . . a . . . state . . . regulatory agency, or a self-regulatory organization." Rule 1017(g)(1) further provides that the applicant can overcome the presumption of denial by "demonstrating that it can meet each of the standards in Rule 1014(a), notwithstanding the existence of any of the [triggering] events."

- FINOP A's 2005 Settlement. On July [ ], 2005, NASD issued an order accepting an offer of settlement from FINOP A. Without admitting or denying the allegations of the complaint, FINOP A consented to and accepted findings that he, while acting as a FINOP for another member firm, permitted that broker-dealer to engage in a securities business on three days over a six-week period in late 2003/early 2004 while failing to maintain its required minimum net capital, in violation of Conduct Rule 2110. FINOP A consented to a $7,500 fine and a censure.[5]

- The Member Firm's 2005 State 4 Stipulation and Consent. On September [ ], 2005, the State 4 Division of Securities accepted a stipulation and consent to findings that the Member Firm acted as an unlicensed broker-dealer and employed an unlicensed broker-dealer agent. The record does not clearly indicate what the sanctions against the Member Firm were, but they included, at least, an order to make a rescission offer.[6]

During the application, Member Regulation neither addressed, nor asked the Member Firm to address, four additional events that triggered the rebuttable presumption of denial.[7]

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[5] According to FINOP A's Uniform Application for Securities Industry Registration or Transfer ("Form U4"), on May [ ], 2005, Firm F, LLC ("Firm F") terminated FINOP A because it was "informed of disciplinary proceedings against . . . FINOP A regarding an alleged violation of NASD Net Capital Rule 2110." Contrary to Member Regulation's suggestion in its decision, this does not separately trigger the rebuttable presumption of denial because there is no evidence that Firm F conducted its own investigation into FINOP A's conduct. *See* Membership and Registration Rules 1017(g)(1) and 1014(a)(3)(C) and (D).

[6] A November [ ], 2006 amendment to the Member Firm's Form BD contains different descriptions of the sanctions: the "resolution detail" section indicates that the sanctions consisted of an order to make a rescission offer to the investor at issue, whereas the "principal sanctions" section indicates that they also included a cease and desist order, a censure, a bar of an unspecified scope, and a fine of an unspecified amount. In addition, the "restitution detail" section of a *pro forma* September [ ], 2006 amendment to the Member Firm's Form BD states that the sanctions included a rescission offer and a $5,000 fine.

[7] These four events were as follows:

- The Supervisor's 2005 State 4 Stipulation and Consent. In a matter related to the Member Firm's 2005 State 4 Stipulation and Consent, on September [ ], 2005, the State 4 Division of Securities accepted a stipulation and consent that the Member Firm acted as an unlicensed broker-dealer agent in State 4. The Supervisor's Form U4 does not clearly explain what sanctions were imposed: the "resolution detail" section discloses that the Supervisor was fined $5,000, ordered to make an offer of rescission and refund the commission he received, but the "principal sanction" section discloses that the sanctions also included a cease and desist order, a censure, and a bar.

[Footnote continued on next page]

In analyzing whether the Member Firm rebutted the presumption of denial arising from these events, Member Regulation found that the Member Firm did not show that "[it] and its associated persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and NASD Rules, including observing high standards of commercial honor and equitable principles of trade," as required by Membership and Registration Rule 1014(a)(3), for several reasons. First, Member Regulation expressed various concerns relating to whether the Member Firm and FINOP A would be capable of complying with the Member Firm's financial-related compliance responsibilities.[8] Second, Member Regulation found that the Member Firm "did not produce procedures or documents to demonstrate that the [Member Firm's 2005 State 4 Stipulation and Consent] had been adequately addressed" but, instead, stated only that that matter was "closed." Third, Member Regulation found that the Member Firm did not update its Form BD with information about the Member Firm's 2005 State 4 Stipulation and Consent until 18 months after that matter was resolved, which was not timely. For these reasons, Member Regulation found that the Member Firm had failed to satisfy Rule 1014(a)(3).

Member Regulation also found that the Member Firm failed to demonstrate that NASD did not "possess any information indicating that the Applicant may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or NASD rules," as required by Rule 1014(a)(13). Member Regulation explained that the

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- The Member Firm's 2001 AWC. On July [ ], 2001, NASD accepted a Letter of Acceptance, Waiver, and Consent ("AWC"), in which the Member Firm consented to and accepted, without admitting or denying the allegations, findings that the Member Firm filed its December [ ], 2000 quarterly FOCUS report 34 days late, in violation of Exchange Act Rule 17a-5 and Conduct Rule 2110, and a $1,000 fine.

- The Member Firm's 2000 Suspension. Between April [ ] and May [ ], 2000, NASD suspended the Member Firm's membership for failing to submit its annual audited report for the period ending December [ ], 1999.

- The Member Firm's 1999 Suspension. Starting on July [ ],1999, NASD suspended the Member Firm's membership for 56 days for failing to file its annual audit report for the period ending December [ ], 1998.

[8] In this regard, Member Regulation noted that FINOP A's net capital rule violations were similar to the financial responsibility rule violations at issue in the Member Firm's 2004 Fine and Censure. Member Regulation also was not convinced that the "[FINOP A's] functions are now performed adequately," considering that FINOP A worked part-time and off-site, and was employed by 11 other firms. Finally, Member Regulation found that the Member Firm did not produce procedures regarding the handling of customer funds and/or securities until NASD staff requested them in its November [ ], 2006 request for information.

Member Firm "has provided conflicting and incomplete information throughout the application" and that "[t]he staff has identified several situations in which the Member Firm either did not possess knowledge of vital Member Firm structure or was unaware of information brought to their attention by the staff." Member Regulation described three events that led it to this conclusion.

First, Member Regulation wrote that the Member Firm was "totally unaware" of assertions in documents filed with the SEC by "Firm G" ("Firm G"), a company for which the Member Firm had conducted a private placement, that the Member Firm "is controlled by Individual A." Putting its concern in context, Member Regulation noted that Individual A had a recent disciplinary history involving making misrepresentations and causing the inaccurate filings of corporate documents.[9] Member Regulation concluded that, although the Member Firm denied that Individual A had any role at the Member Firm and represented that its legal team was investigating the statement made by Firm G, "until these items are fully addressed and corrected the application does not appear to meet the standards" in Rule 1014(a)(13).

Second, Member Regulation found that the Member Firm failed to disclose to NASD staff that the CEO of the Member Firm owned approximately 10 percent of the shares of Firm D, the holding company for Firm B. Member Regulation further noted that, after Member Regulation discovered the CEO's ownership interest and questioned him about it, the CEO then explained that he "was issued 10 million shares in Firm D at some point in early 2005," and that "[h]e has no input or any other relationship with Firm D or with Firm B."[10]

Finally, Member Regulation found that the CEO inaccurately informed NASD staff that "he was not aware of any [pre-hire] screening of Employee A and . . . that he had no idea why anyone would screen Employee A." Member Regulation noted that the CEO's verbal statements conflicted with: (1) a CRD report showing that a Member Firm user identified as "CEO1" conducted a pre-hire screen of Employee A on July [ ], 2006; and (2) a letter dated July [ ], 2006, from Employee A authorizing the Member Firm to access his CRD records. For all of these reasons, Member Regulation found that the Member Firm had failed to satisfy Rule 1014(a)(13).

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[9] On July [ ],2006, Individual A settled an SEC enforcement action alleging that he caused Firm G, a company for which he was the controlling shareholder and a director, to make inaccurate disclosures regarding that company's revenues and expenses, in violation of Section 10(b) of Exchange Act and Rule 10b-5 thereunder. Individual A consented to cease and desist from committing future violations of Section 10(b) and Rule 10b-5 ("Individual A's 2006 Cease and Desist Order"). In a related civil money penalty action in federal court, Individual A offered to pay a $25,000 civil money penalty.

[10] Member Regulation's references in its decision to Firm B, Firm C, and Firm D (two of which share the same corporate name) were imprecise. Our summary of Member Regulation's findings reflects our interpretation of what Member Regulation intended to write.

Notwithstanding its findings that the Member Firm failed to satisfy two membership standards, Member Regulation granted the section of the Member Firm's application that sought to engage in new lines of business. Member Regulation also partially granted the Member Firm's request to expand its size, permitting the Member Firm: (1) to "employ no more than 30 associated persons (registered and unregistered) who have direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, including the immediate supervisors of such persons;[11] and (2) to operate no more than nine branch offices." On January [ ], 2007, the Member Firm appealed from the restrictions that Member Regulation imposed.

## II. NAC Hearing

On February [ ], 2007, a subcommittee ("Subcommittee") of the National Adjudicatory Council ("NAC") held a hearing in connection with the Member Firm's application for review. The Member Firm presented three witnesses, the CEO, the Chairman, and FINOP A, and introduced 22 exhibits into evidence. Member Regulation presented two witnesses, Compliance Examiner 1, an NASD compliance examiner in NASD's State 1 District office, and Compliance Examiner 2, a supervisor of examiners in NASD's State 1 District office, and introduced 36 exhibits into evidence. Pursuant to the Subcommittee's request, the parties also filed post-hearing briefs.

Our summary of the NAC hearing is in five parts. In Part II.A, we address the Member Firm's evidentiary and procedural objections. In Part II.B, we explain why the Member Firm has filed this application. In Parts II.C and II.D, we summarize the evidence concerning Member Regulation's decision that the Member Firm did not meet Rule 1014(a)(3) and 1014(a)(13), respectively. Finally, in Part II.E, we review the evidence on the specific restrictions that Member Regulation imposed.

### A. Evidentiary and Fairness Objections

At the hearing, Member Regulation offered evidence on a variety of factual contentions that were not expressly stated in its decision letter. The Member Firm objected on relevance and fairness grounds to all questions, testimony, and documentary evidence concerning issues that were not expressly mentioned in the decision. Member Regulation responded that it was not required to include all of its grounds in the decision itself, and that it provided to the Member Firm notice of all issues raised in the hearing through the NASD staff's requests throughout the application and by notifying the Member Firm of all the documents that were considered in issuing the decision. It also contended that the Member Firm's reading of the grounds provided in the letter was unduly crimped. At the hearing, the Subcommittee reserved judgment on the Member Firm's objections, permitted the questioning and introduction of evidence on all issues,

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[11] As discussed below, there arose during the hearing on this matter some question as to whether Member Regulation intended to permit the Member Firm to employ up to 30 registered representatives. *See infra* Part III.D.2.

and requested that the parties introduce whatever evidence they wished concerning the Member Firm's objection relating to notice. The Subcommittee also requested posthearing briefing on the question. Before summarizing the evidence at the hearing, it is first necessary to address the Member Firm's objections.

1. Evidentiary and Notice Standards

In evaluating the Member Firm's evidentiary and procedural objections, we are primarily guided by fairness principles contained in the Exchange Act. Section 15A(b)(8) of the Exchange Act requires, in pertinent part, that NASD rules "provide a fair procedure" for the prohibition or limitation by NASD of any person with respect to access to services offered by NASD or an NASD member. In addition, Section 15A(h)(2) of the Exchange Act provides that NASD, in any such proceeding, "shall *notify* such person of, and give him an opportunity to be heard upon, the *specific grounds for . . . prohibition or limitation under consideration* and keep a record" (Emphasis Added). *See also BFG Sec., Inc.*, 55 S.E.C. 276, 287 (2001) (holding that NASD is required to conduct "fair proceedings" in membership cases).

Contrary to the Member Firm's arguments, providing adequate notice of the grounds of Member Regulation's decision does not hinge on whether grounds were expressly addressed in that decision. In an administrative proceeding, "the question on review is not the adequacy" of the document, but "the fairness of the entire procedure." *Jonathan Feins*, 54 S.E.C. 366, 378 (1999) (concerning administrative pleadings) (quoting *Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 262 (D.C. Cir. 1979)). The Commission has held that "[a]s long as a party to an administrative proceeding is reasonably apprised of the issues in controversy and is not misled, notice is sufficient." *KPMG Peat Marwick, LLP*, 55 S.E.C. 1, 4 (2001), *petition for review denied*, 289 F.3d 109 (D.C. Cir. 2002).[12]

With respect to the means of notifying the applicant of the grounds of the decision, Member Regulation's decision is the primary way for Member Regulation to provide notice of its concerns, especially considering that prehearing briefs are not always required in membership appeals. *See* Membership and Registration Rules 1015(a), 1017(g)(2). However, because all that is required is to "reasonably apprise" the applicant of the grounds of the decision, we are not limited to considering the statements in Member Regulation's decision itself, as the Member

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[12] Similarly, the Commission has held that adequate notice is provided when the subject of NASD's decision "understood th[e] issue and [was] afforded [a] full opportunity to litigate it at the hearing." *Fox & Co. Invs., Inc*., Exchange Act Rel. No. 52697, 2005 SEC LEXIS 2822, at *32 n.34 (Oct. 28, 2005) (citing cases); *see also Ira Weiss*, Exchange Act Rel. No. 52875, 2005 SEC LEXIS 3107, at *51 (Dec. 2, 2005) (citing *Aloha Airlines*, 598 F.2d at 262), *petition for review denied*, 468 F.3d 849 (D.C. Cir. 2006); *Thomas E. Warren, III*, 51 S.E.C. 1015, 1019 n.18 (1994) ("The Commission has previously recognized that, even if an administrative pleading is defective, the defect can be remedied if the record demonstrates that the respondent understood the issue and was afforded a sufficient opportunity to justify his conduct . . . ."), *aff'd*, 69 F.3d 549 (10th Cir. 1995) (table).

Firm would limit us. It is also appropriate to consider prehearing communications between Member Regulation and the applicant firm.[13] Advancing new grounds in defense of Member Regulation's decision for the first time at a NAC hearing, however, can raise fairness concerns where a party is not reasonably apprised of such grounds.[14] As for the substance required to apprise reasonably the applicant of the grounds underlying the decision, Member Regulation's decisions and prehearing communications, like administrative pleadings in disciplinary cases, are "very liberally construed." *Feins*, 54 S.E.C. at 378.[15]

2. The Issues of Which the Member Firm Lacked Notice

Applying this guidance, we agree with the Member Firm that Member Regulation failed to provide the Member Firm with notice about several issues that Member Regulation now claims were relevant to its decision. These issues include concerns stemming from: (1) the Member Firm's disclosure during the application that the Supervisor was funding the Member Firm's planned business expansion; (2) the prospect that the Member Firm might be seeking to employ Firm B representatives that might subject the Member Firm to taping requirements; and (3) the adequacy of the Member Firm's written supervisory procedures addressing customer funds and securities. Even read liberally, neither Member Regulation's decision, nor its prehearing filing, reasonably apprised the Member Firm that these were grounds of its decision.

The Member Firm has not specifically explained how it would have proceeded differently had it received proper notice of these issues, so it is not clear how the Member Firm has been prejudiced by the defective notice. *Cf. RFG Options Co.*, 49 S.E.C. 878, 885 (1988) (holding

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[13] *Cf. William C. Piontek*, Exchange Act Rel. No. 48903, 2003 SEC LEXIS 2940, at *18-19 (Dec. 11, 2003) (holding that respondent had notice that allegations pertained to a specific customer not named in complaint, where customer was on witness list and the parties discussed at a prehearing conference that customer's participation at the hearing); *Feins*, 54 S.E.C. at 378-79 (considering exhibits provided before the hearing in analyzing whether notice of the conduct at issue was provided); *see also Robert Thomas Clawson*, Exchange Act Rel. No. 48143, 2003 SEC LEXIS 1598, at *17-19 (July 9, 2003) (considering both order instituting proceedings and testimony given at hearing when analyzing whether notice of issues was provided), *petition for review denied*, No. 03-73199, 2005 U.S. App. LEXIS 19499 (9th Cir. Sept. 8, 2005).

[14] *Cf. NLRB v. W. Temp. Servs., Inc.*, 821 F.2d 1258, 1263-64 (7th Cir. 1987) ("[N]otice on the day of the hearing is not reasonable notice."); *but cf. BFG Sec.*, 2001 SEC LEXIS 1521, at *15-16 (permitting NASD staff to raise on appeal new concerns about firm's threshold eligibility for NASD membership, considering that the firm had failed to disclose such facts during the initial application process).

[15] *Cf. Weiss*, 2005 SEC LEXIS 3107, at *51 (finding that order instituting proceedings notified respondent of alleged violations of subsections of Section 17(a) of the Securities Act of 1933 ("Securities Act") that required only negligence, despite the fact that the order did not specify such subsections, where the allegations "sounded in negligence").

that respondents failed to show prejudice from defective notice, where they did "not explain[ ] how they would have proceeded differently had the notice they received been more to their liking"). Further consideration of these issues, however, would not materially impact our decision, in light of our discussion below in Part III.D of the restrictions imposed. Accordingly, we shall proceed without relying on any of the evidence introduced at the hearing concerning the three issues of which Member Regulation failed to provide notice.[16]

3. The Issues on Which the Member Firm Did Receive Notice

We reject the Member Firm's arguments, however, that it lacked fair notice that certain other issues were among the grounds of Member Regulation's decision. First, we reject the Member Firm's argument that it lacked notice that various issues pertaining to whether Individual A was a controlling person at the Member Firm were among the grounds of Member Regulation's decision. In its decision, Member Regulation wrote, "[d]ocuments filed with the SEC for . . . Firm G. . . identif[y] Individual A as the controlling person of the Member Firm" and that the Member Firm responded that such statements "are blatantly wrong and without any substance." Notwithstanding that Member Regulation referenced only the Firm G filing, the gravamen of Member Regulation's concerns was the relationship of Individual A to the Member Firm. *Cf. Feins*, 54 S.E.C. at 378-79 (holding that respondent was on notice that specific trades not listed in the complaint were relevant, where the statement of charges described the conduct at issue, specified when it took place, and identified the customer); *First Capital Funding, Inc.*, 50 S.E.C. 1026, 1028 (1992) (in assessing whether notice of charges was provided, SEC looked to the "gravam[e]n of the charge" and the "theory" rather than the "exact nature" of the particulars of the charge). Furthermore, Member Regulation's concern about the ties between Individual A and the Member Firm was specific enough to reasonably apprise the Member Firm that such ties were relevant issues. *Cf. Feins*, 54 S.E.C. at 378-79.

Likewise, we reject the Member Firm's argument that it did not have notice that the Member Firm's failure to hire the Accountant ("Accountant") as the Member Firm's accountant was also part of the grounds for Member Regulation's decision. In its decision, Member Regulation expressed the concern about whether FINOP A had sufficient time to devote to his FINOP duties. Thus, events that impacted on the question of whether FINOP A would have sufficient time to fulfill his FINOP duties would be relevant to that issue. This included the facts concerning the Member Firm's decision not to hire the Accountant, whom the Member Firm explained during the application would be a primary support for FINOP A.

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[16] The Member Firm argues that merely allowing Member Regulation to offer such evidence concerning these issues was prejudicial to the Member Firm. We disagree. Adjudicators in NASD adjudicatory proceedings are "capable of disregarding information" that they should not consider. *Dist. Bus. Conduct Comm. v. Custable*, Complaint No. C8A910006, 1992 NASD Discip. LEXIS 94, at *59 (NBCC Apr. 21, 1992), *aff'd*, 51 S.E.C. 643 (1993). In any event, our review of the Subcommittee's recommendation ensures that no prejudice taints the outcome.

We also reject the Member Firm's argument that it lacked notice that any of its disciplinary history beyond the Member Firm's 2004 Fine and Censure and FINOP A's 2005 Settlement was at issue. A broker-dealer reasonably should expect that anything in its disciplinary history that raises the rebuttable presumption of denial under Rule 1017(g) could be used to support the decision. Moreover, prior to the hearing, Member Regulation provided the Member Firm with proposed exhibits that documented the disciplinary events at issue. For these reasons, it should have come as no surprise to the Member Firm that the NAC could rely upon disciplinary actions other than the Member Firm's 2004 Fine and Censure and FINOP A's 2005 Settlement.

The question remains, however, as to whether the Subcommittee's decision not to rule on the Member Firm's evidentiary and procedural objections at the hearing itself denied the Member Firm a fair opportunity to address the evidence at issue. We conclude that the Subcommittee's approach did not deny the Member Firm a fair hearing. A fair proceeding requires providing notice of the grounds of the decision and "'afford[ing] [a] full opportunity' to litigate the issues." *Cf. Piontek*, 2003 LEXIS 2940, at *18-19 (quoting *KPMG Peat Marwick, LLP*, 2001 SEC LEXIS 2754). As explained above, the Member Firm was on notice of Member Regulation's intention to put these matters into the record. Furthermore, the Member Firm had sufficient opportunity to make a record at the hearing as to those matters, in the alternative to arguing that they were not properly considered as a matter of law. The Subcommittee, in turn, gave the Member Firm a full opportunity to present evidence on all such issues if it wished to do so, clearly and accurately apprising the Member Firm how the Subcommittee would proceed in light of the Member Firm's objections. In fact, the Member Firm at times took advantage of that opportunity, such as providing evidence about its recent hiring of the Accountant.[17]

In any event, the Member Firm has not specifically apprised us of the type of evidence it would have sought to introduce on these issues. Although the Member Firm stated at the hearing that it would have further questioned the Chairman of the Member Firm, it did not explain what the Chairman would have testified about.

Thus, the Member Firm was not prejudiced in any way by the Subcommittee's decision to request posthearing briefing before deciding the issue of whether or not the factual issues in question could be properly raised by Member Regulation and considered by the Subcommittee and, ultimately, by this body. We now turn to a summary of the salient evidence.

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[17] Thus, this case is wholly unlike cases where a litigant is prejudiced by relying on misinformation to its detriment. *See, e.g.*, *Williams v. Runyon*, 130 F.3d 568, 573 (3d Cir. 1997) (holding that a party was prejudiced through reliance on a ruling that an adjudicator later changed); *Henry Bierce Co. v. NLRB*, 23 F.3d 1101, 1107-08 (6th Cir. 1994) (finding that party was prejudiced through reliance on a statement of charges that a prosecutor amended on the final day of the hearing); *see also United Credit Bureau v. NLRB*, 643 F.2d 1017, 1022 n.6 (4th Cir. 1981) (finding that party was not prejudiced from an ambiguous notice setting a hearing where, *inter alia*, the ALJ "adequately apprised counsel of the posture of the case" at the hearing).

B. Purpose of the Application

The CEO testified that the Chairman hired the CEO to "build and expand [the Member Firm]" from a firm that handled private placements and private investment in public equity ("PIPE") transactions into "a full-service firm" that "offer[s] public money to companies looking for that" and that "attend[s] to the retail customer and their portfolios." The CEO explained that adding business lines was to provide incentives for customers to work with, and for general securities representatives to join, the Member Firm, which in turn would attract "bigger [and] better deals." The Member Firm had already invested time and resources to develop a new business plan and had hired four representatives, two of whom came from Firm B. The CEO explained, however, that at "the 11th hour," the Member Firm realized that its membership agreement did not permit it to engage in these new business lines. As a result, the Member Firm filed this application.

C. Rule 1014(a)(3) Issues

1. The Member Firm's Capability of Complying with Financial Responsibility Rules

As explained above, the Member Firm's 2004 Fine and Censure, which involved filing a late annual audit report, filing a materially inaccurate FOCUS report, and maintaining books and records with inaccurate net capital computations, and FINOP A's 2005 Settlement, which involved a net capital rule violation, were among the events raising a rebuttable presumption that the Member Firm's application should be denied. Much of the evidence concerning whether the Member Firm had rebutted that presumption centered on the Member Firm's employment of FINOP A as its FINOP.

The Member Firm represented that FINOP A, who resides in City 4, State 3, administers "all FOCUS report functions and related responsibilities." The Member Firm hired FINOP A in September 2004, approximately six months before NASD initiated its disciplinary action against him.

The Member Firm presented evidence purporting to show that FINOP A's 2005 Settlement is a minor violation. Since FINOP A's 2005 Settlement, which involved conduct that occurred in 2003, he has continued to serve as the FINOP for the Member Firm as well as several other broker-dealers, and he is currently registered as a FINOP with 11 other broker-dealers. There have been no disciplinary actions against FINOP A since his 2005 Settlement. The Member Firm also pointed to FINOP A's explanation in his Form U4 that his violation resulted from the broker-dealer's failure to provide him with certain information, and that he reported the net capital issue to NASD as soon as he became aware of it.

The Member Firm also attempted to demonstrate that FINOP A had enough time to fulfill the FINOP role. The CEO testified that no situations have arisen where FINOP A lacked sufficient time to perform his duties at the Member Firm. The CEO also testified that, since Member Regulation's decision, the Member Firm has hired the Accountant as the Member Firm's chief financial officer, which "will make [FINOP A]'s function much easier." The

Member Firm explained that "[d]ay to day interaction with the Member Firm's financial picture will be monitored by [the Accountant] and reflected to . . . [the Chairman] and . . . [the CEO]," and that "[a]ny abrupt or sudden situations . . . will be brought to the FINOP's attention and addressed immediately."

Similarly, the Member Firm attempted to rebut a suggestion in Member Regulation's decision that the Member Firm's reliance on FINOP A was indicative of the Member Firm's past attempts to operate with insufficient personnel. The Member Firm introduced evidence showing that, since the conduct at issue in the Member Firm's 2004 Fine and Censure, the Member Firm has hired several persons, including: (1) the CEO, who has "over 20 years of experience," as CEO and chief operating officer; (2) the President, who has "approximately 25 years of experience," as president; (3) FINOP A as FINOP; and (4) the Accountant as chief financial officer. The CEO added that the Chairman has "40 years of experience." The Member Firm also represented that "a totally new/revamped Written Supervisory Procedures Manual has been implemented," and that the Member Firm negotiated an agreement with a "nationally known and respected clearing firm."

Member Regulation witness Compliance Examiner 1 explained that the Member Firm's request to add "an entirely new retail business line" and embark on "a very large expansion" raised questions about whether the Member Firm's financial controls structure was adequate. Compliance Examiner 1 testified that the Member Firm did not explain how it planned to address that concern other than by hiring FINOP A, which itself was problematic. Specifically, Compliance Examiner 1 testified that the fact that FINOP A's and the Member Firm's disciplinary histories were similar in nature "raised a significant concern." Compliance Examiner 1 also testified that there were questions about whether FINOP A had sufficient time and support to fulfill the FINOP role were the Member Firm to expand as requested. The facts raising such questions were that FINOP A was associated with 12 firms and worked off-site, and that after the Member Firm represented it would hire the Accountant in an accountant role that would "aid and assist the [FINOP]," it subsequently represented that its discussions with the Accountant had ended.[18] Member Regulation also introduced evidence showing that the Member Firm's 2004 Fine and Censure was only one of several instances where the Member Firm failed to comply with the financial and operations rules.[19]

2. The Member Firm's Capability of Complying with Registration Rules

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[18] The Member Firm hired the Accountant after Member Regulation issued its decision.

[19] In its decision, Member Regulation also found that the Member Firm did not produce procedures regarding the handling of customer funds and/or securities until NASD staff requested them in its November [ ], 2006 request for information. At the hearing, however, Compliance Examiner 1 conceded that this statement was inaccurate.

The Member Firm's and the Supervisor's 2005 State 4 Stipulations and Consents also raise a rebuttable presumption that the Member Firm's application should be denied. Because both matters involved acting as an unlicensed broker-dealer or broker-dealer agent, they raise questions about the Member Firm's capability of complying with registration requirements.

The Member Firm presented evidence to support its argument that the State 4 matters should not preclude the application from being approved in full. The Member Firm claimed that the violations stemmed from the Supervisor's decision to take a commission on an investor's investment in a private placement, and that the Supervisor did so only after receiving legal advice that it was consistent with State 4 securities regulations. The Member Firm also noted that it alerted State 4 securities regulators to the transaction and that State 4 later approved the Member Firm's application to conduct business in State 4. Finally, the Member Firm stated that the State 4 matters "predated our management changes and system/compliance upgrades" and that it "now comprehensively monitor[s] all transactions within states in question before any private transactions are performed."

Compliance Examiner 1 testified, on the other hand, that the Member Firm had not addressed the steps it would take to ensure future compliance with the kinds of requirements involved in the State 4 matters.

3. The Member Firm's Capability of Complying with Disclosure Requirements

On September [ ], 2005, the Member Firm's 2005 State 4 Stipulation and Consent was resolved. The Member Firm did not update its Form BD with this information until November [ ], 2006, after NASD staff informed the Member Firm of the inaccuracy. Similarly, on May [ ], 2005, a State 4 disciplinary matter was initiated against the Supervisor, and on September [ ], 2005, the Supervisor's 2005 Stipulation and Consent was resolved. The Supervisor's Form U4 was not updated with any of this information until October [ ], 2006. The CEO explained that the person who was responsible for making required CRD updates had left the Member Firm and that some updates had not been made. The CEO further testified that the Member Firm promptly amended its Form BD when it was apprised of the error.

Compliance Examiner 1 emphasized that the Member Firm did not properly update the Form BD until more than one year after that form should have been updated. Compliance Examiner 1 explained that the undisclosed information was "vital" because it was an event that Member Regulation was required to consider in evaluating Member Firm's membership application. Compliance Examiner 1 further testified that Firm B's Form U4 "did not disclose any mention of [his State 4] action" until October [ ], 2006. Member Regulation also pointed to other past instances where the Member Firm or its associated persons failed to properly amend CRD forms, or amended them inaccurately.

D. Rule 1014(a)(13) Issues

The parties presented evidence concerning the three issues that led Member Regulation to conclude that the Member Firm failed to demonstrate that NASD does not possess any

information indicating that the Member Firm may circumvent, evade, or otherwise avoid compliance with federal securities laws or NASD rules.

1. Questions Concerning Firm E's Status at the Member Firm

In a Form SB-2/A filing, Firm G represented that "the Member Firm is controlled by Individual A." At the hearing, the CEO of the Member Firm reiterated the Member Firm's position that the statement in the Firm G filing was wrong, and he testified that Individual A has never been registered with, associated with, or a controlling person of the Member Firm. Attempting to corroborate this position, the Member Firm introduced a letter dated February [ ], 2007, from Law Firm B, the law firm that represented Firm G, conveying its "understanding, based on representations made to us by Individual A and the Member Firm[ ], . . . that Individual A is not affiliated in any way with the Member Firm[ ], whether as an officer, director, registered representative, investor, or otherwise."

Member Regulation pointed to facts that purportedly show why the Firm G filing raised questions about whether Individual A was or is a controlling person of the Member Firm. These facts included statements in the Member Firm's business plans describing ties to Firm E, as well as an impermissible payment of commissions from the Member Firm to Firm E.

2. Conflicting Information Concerning the Pre-Hire Screening of Employee A

On or around October [ ], 2006, NASD staff asked the CEO whether he had done a CRD pre-hire screening of Employee A. According to the CEO, he told NASD staff that he had not done so but that "if you have something to show that I did . . ., show me." The CEO testified that NASD staff then sent him a document showing that the Member Firm had performed a pre-hire screen of Employee A, which the CEO confirmed by reviewing his files.[20] The CEO testified that, in response to the "next NASD request," he admitted that he had conducted the pre-hire screen.[21]

Compliance Examiner 1 presented a slightly different version of these events. Compliance Examiner 1 testified that when she asked the CEO if he had done a pre-hire search of Employee A, the CEO responded that he had not. Compliance Examiner 1 testified that once she presented the CEO with the CRD report showing that the CEO had done so, the CEO acknowledged that he had conducted the pre-hire screen.

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[20] Consistent with the CEO's testimony, in an e-mail dated on October [ ], 2006, Compliance Examiner 1 informed the CEO that a CRD report demonstrated that on July [ ], 2006, a user at the Member Firm named "[CEO's first initial, lastname]1" performed a preregistration screening for Employee A.

[21] The CEO is evidently referring to a letter dated October [ ], 2006, in which the Member Firm provided to NASD staff a letter dated July [ ], 2006, from Employee A authorizing the Member Firm to "access my CRD records for informational purposes only."

During the application process, the Member Firm informed NASD staff that it was not currently considering Employee A for employment. But in his testimony, the CEO allowed that it was a "possibility" that the Member Firm had considered hiring Employee A. It is undisputed that, at the time of the pre-hire screen, Employee A had recently left Firm B.

3. The CEO's Alleged Failure to Disclose an Ownership Interest in Firm B

A draft prospectus for Firm D represents that the CEO has an 8.57% ownership interest in that company's common stock. The CEO testified that, in a telephone conversation that occurred sometime before July [ ], 2006, NASD staff asked him whether he owned any shares in any broker-dealer. The CEO testified that he truthfully responded that he did not, but that he did own 10 million shares of the parent company of Firm B, Firm D. The CEO also admitted at the hearing that he was not aware of any other business in which Firm B had an interest or ran other than Firm D.

Compliance Examiner 1 testified that when the CEO initially told NASD staff that he did not own an interest in a broker-dealer, he did not disclose his indirect interest in Firm B. Compliance Examiner 1 further testified that NASD staff then conducted their own research and discovered that CEO did, in fact, have an ownership interest in Firm D. According to Compliance Examiner 1, it was not until a subsequent conversation that occurred at most two weeks later when the CEO admitted that he did own shares of the parent company of a broker-dealer.[22]

E. Restrictions

Compliance Examiner 1 and Compliance Examiner 2 both testified about how Member Regulation decided upon the specific restrictions on the Member Firm's associated persons and offices. Compliance Examiner 2 testified that Compliance Examiner 1 recommended the restrictions, and that Member Regulation "collectively arrived at [the] decision." Compliance Examiner 2 explained that the Member Firm's failures to meet all the membership standards, combined with the fact that the Member Firm had requested "a seven-fold" expansion, raised "concerns [about] whether the firm's supervisory structure could accommodate that growth." Compliance Examiner 2 further testified that "we didn't want to . . . completely stop the firm's expansion, but we wanted to ensure that the firm could expand . . . commensurate with what their supervisory structure was." Similarly, Compliance Examiner 1 testified that Member Regulation believed that the Member Firm could be approved to grow "in a controlled manner."

Compliance Examiner 1 and Compliance Examiner 2 testified that Member Regulation arrived at the 30-associated-person restriction because it permitted "controlled growth," the

[22] The Member Firm argues that Compliance Examiner 1 testified that the CEO "volunteered" that he owned shares of Firm D. Nothing in Compliance Examiner 1's testimony, however, supports the Member Firm's characterization of that testimony.

Member Firm's supervisory, financial, and operational systems were "adequate" for such an expansion, it was the number set forth in the Member Firm's one-year business plan as projected in *pro forma* documents, and it was a "reasonable accommodation in light of our concerns." Compliance Examiner 2 further testified that restricting the Member Firm to nine offices was "in keeping with the increase" in brokers. Compliance Examiner 1 added that the specific restrictions were intended to permit an expansion of approximately twice what the "safe harbor" provision, Membership and Registration IM-1011-1, would have allowed. Finally, both Compliance Examiner 1 and Compliance Examiner 2 testified that there was nothing preventing the Member Firm from reapplying for further expansions.

Compliance Examiner 1 could not opine on whether looser restrictions also would have been consistent with allowing for "controlled growth." Instead, Compliance Examiner 1 noted that the Member Firm had not explained in its *pro forma* financial documents or its business plan how it would grow to the requested size.[23] Similarly, Compliance Examiner 2 testified that Member Regulation did not consider whether looser restrictions would have been equally appropriate as the restrictions that Member Regulation imposed. Instead, Compliance Examiner 2 explained that Member Regulation considered whether the Member Firm's requested expansion or Compliance Examiner 1's recommended restrictions were reasonable based on Member Regulation's concerns.

The CEO testified that the Member Firm does not intend to hire 75 representatives all at once, but instead seeks the ability to grow to that size if an opportunity to add an office or hire a broker "presents itself." However, there was also concern expressed that having to reapply for further expansion could delay significantly the Member Firm's growth, given the time that the application process can be expected to take from start to finish.

## III. Discussion

After a thorough review of the record, we affirm Member Regulation's findings that the Member Firm has not met its burden of establishing compliance with the membership standards in Membership and Registration Rules 1014(a)(3) and (13) sufficient to justify the granting of the application with no restrictions. We also affirm the numerical restrictions on the associated persons and offices imposed by Member Regulation, as we understand they were intended to apply. We modify, however, the nature of the associated persons restriction. Finally, we remand the proceeding to permit the Member Firm to file an amended application within a certain time period and with certain conditions to be met.

### A. Membership Continuance Application Requirements

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[23] Likewise, when asked why the restrictions were based on the *pro forma* projections instead of the Member Firm's request, Compliance Examiner 1 testified that the Member Firm had not addressed in its business plan how the Member Firm "planned to meet their request for 75 registered representatives and 15 branches."

Membership and Registration Rule 1017(g)(1)(A) provides that, in examining an application for approval of a material change in business operations, Member Regulation is required to determine if the applicant met and "would continue to meet the standards in [Membership and Registration] Rule 1014(a) upon approval of the application." The firm filing a membership continuance application bears the burden of establishing the merits of its application and, in particular, that it meets, and will continue to meet, each of the 14 standards for membership approval contained in Membership and Registration Rule 1014(a). *Cf. Homeland Sec. Fin. Serv. Group, Inc*., Application No. A8A050063, 2006 NASD Discip. LEXIS 23, at *31-32 (NAC Aug. 10, 2006); *Sierra Nev. Sec., Inc*., Application No. M01970005, 1998 NASD Discip. LEXIS 24, at *14-15 (NAC May 11, 1998) (rejecting argument that an applicant need not satisfy each of the standards in Rule 1014), *aff'd, 54 S.E.C. 112 (1999)*. In general, the membership standards are intended to ensure that member firms that materially change their business operations, among other changes, will continue to be capable of satisfying all relevant regulatory requirements for the protection of the investing public, the securities markets, the firm, and other member firms. *Homeland Sec*., 2006 NASD Discip. LEXIS 23, at *32.

Member Regulation found that the Member Firm failed to demonstrate that it satisfied Membership and Registration Rule 1014(a)(3) and (13). As explained below, we affirm Member Regulation's findings.

B. Membership and Registration Rule 1014(a)(3)

1. The Member Firm Has Failed to Demonstrate that It Is Capable of Complying with Financial Responsibility Rules

Of the events that Member Regulation referenced in its decision that raise a presumption of denial, two of them specifically concern past failures to comply with the financial responsibility rules: the Member Firm's 2004 Fine and Censure and FINOP A's 2005 Settlement. "In determining whether an applicant has overcome the presumption [of denial], NASD staff will consider the applicant's submission in light of the specific standards of Rule 1014(a), the public interest, protection of investors, and NASD's responsibility to provide a fair procedure in accordance with membership rules." *NASD Notice to Members 04-10* (Feb. 2004). Mindful of these principles, we find that the Member Firm has failed to demonstrate that it is capable of complying with the financial responsibility rules, as required by Rule 1014(a)(3).

The Member Firm's 2004 Fine and Censure involved filing a late annual audit report, filing a materially inaccurate FOCUS report, and maintaining books and records with inaccurate net capital computations. Moreover, this was not the first time that the Member Firm has evidenced a failure to comply with financial responsibility rules and related requirements. The Member Firm's record includes the following:

- In a deficiency letter dated January [ ], 2006, from the SEC ("the Member Firm's 2006 SEC Deficiency Letter"), the SEC concluded that, for the period ending October [ ], 2004, the Member Firm failed to maintain an accurate net capital computation, general ledger, and balance sheet, in violation of Section 17(a) of the Exchange Act and Exchange Act Rules 17a-3 and 17a-4.

- In that same 2006 SEC Deficiency Letter, the SEC also concluded that, on June [ ], 2004, the Member Firm paid $149,268 in commissions to a nonmember firm, Firm E, in violation of NASD Rule 2420.

- In a letter of caution dated June [ ], 2005, from NASD ("the Member Firm's 2005 Letter of Caution"), NASD concluded that the Member Firm had overstated its net capital as of October [ ], 2004, by $3,750, in violation of Exchange Act Rule 17a-3.

- In the Member Firm's 2001 AWC, NASD fined the Member Firm $1,000 for failing to timely file a quarterly FOCUS report, in violation of Exchange Act Rule 17a-5 and Conduct Rule 2110.

- In the Member Firm's 2000 Suspension, NASD suspended the Member Firm for failing to file an annual audit report.

- In a letter of caution dated December [ ], 2000 ("the Member Firm's 2000 Letter of Caution"), NASD concluded that the Member Firm filed its FOCUS report for the quarter ending September [ ], 2000, 42 calendar days late, in violation of Exchange Act Rule 17a-5.

- In a letter of caution dated November [ ], 1999 ("the Member Firm's 1999 Letter of Caution"), NASD concluded that the Member Firm had filed a late annual audit.

- In the Member Firm's 1999 Suspension, NASD suspended the Member Firm for failing to file an annual audit report.

Viewed individually, none of these violations was egregious, including the Member Firm's 2004 Fine and Censure, in which a Hearing Panel found that the Member Firm's violations were not intentional and fined the Member Firm only $3,000 for filing a late annual report. In combination, however, they amount to a pattern of violating the financial responsibility and related rules, heightening the Member Firm's burden of demonstrating that it is capable of complying with these rules. *Cf. Dist. Bus. Conduct Comm. v. Respondent 1*, Complaint No. C8A960052, 1998 NASD Discip. LEXIS 63, at *17 n.5 (NAC Oct. 13, 1998) ("[A] securities professional's responsibility to ensure compliance with the securities rules is heightened by prior proceedings by the NASD.").

The Member Firm argues that "part of the problem" that led to the Member Firm's 2004 Fine and Censure was insufficient personnel, and that the Member Firm has hired additional personnel since its violative conduct. Adding experienced personnel to address prior violations that resulted from understaffing is certainly a favorable step. By itself, however, it is not enough to show how the Member Firm is capable of complying with the financial responsibility rules. In this regard, the fact that the Member Firm has employed FINOP A to fulfill the FINOP role

raises—not diminishes—our concerns. FINOP A himself has somewhat recently been found to have violated the net capital rule.[24] Moreover, FINOP A is a part-time, off-site FINOP working with 11 other broker-dealers. Such facts raise questions about whether FINOP A would have sufficient time to devote to the Member Firm if the Member Firm were permitted to both add new business lines and significantly increase in size. The fact that FINOP A may be able to handle the Member Firm today does not answer the question of whether he could handle it as envisioned under the expansion plan.

Although the Member Firm argues that FINOP A's net capital violation does not present "a real issue," there are open questions concerning whether that violation was part of an emerging pattern, perhaps of FINOP A already being stretched thin.[25] Moreover, the Member Firm's characterization of FINOP A's net capital rule violation suggests that it fails to appreciate the importance of compliance with that rule. "The principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation."[26] *Fox & Co. Invs.*, 2005 SEC LEXIS 2822, at *18.

In any event, the Member Firm cannot rebut the presumption of denial raised by its and FINOP A's disciplinary history by, as the Member Firm has tried to do, asserting that past

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[24] The Member Firm's argument that the violation in FINOP A's 2005 Settlement was different from the violations at issue in the Member Firm's 2004 Fine and Censure is of no consequence. Because FINOP A is an associated person of the Member Firm, his violation also raises the rebuttable presumption of denial. Rule 1017(g)(1). In any event, FINOP A's violation is similar in nature to the Member Firm's violations because the overall purpose of the net capital rule and the financial reporting rules is to ensure that a firm maintains sufficient net capital. *See* Clifford E. Kirsch, *Broker-Dealer Regulation* at §15:6 (2004) ("Compliance with the net capital requirements is also a function of accurate books and records. . . . [A firm's] inability to demonstrate that it has sufficient excess net capital becomes the practical equivalent of net capital non-compliance.").

[25] In the Member Firm's 2006 SEC Deficiency letter, the SEC found that the Member Firm maintained an inaccurate net capital computation, general ledger, and balance sheet for the period ending October [ ], 2004. Likewise, the Member Firm's 2005 Letter of Caution, indicates that the Member Firm overstated its net capital in October 2004, for a different reason. Although neither of these mentioned FINOP A, the violations occurred while FINOP A was serving as the Member Firm's FINOP.

[26] The Member Firm argues that Member Regulation's concerns about FINOP A's disciplinary history are "trumped up nonsense" because NASD otherwise "would have done something . . . more drastic, when he sought to register in the first place." The disciplinary action against FINOP A had not been initiated, however, at the time FINOP A registered with the Member Firm.

violations are of no concern or collaterally attacking them. *See BFG Sec.*, 2001 SEC LEXIS 1521, at *5 n.5 (noting in a membership proceeding that the NAC "in no way condoned" firm's collateral attack on separate regulatory proceedings that had already concluded). Rather, the Member Firm must explain the steps it will take to ensure that such violations do not happen again. *See Monroe Parker Sec., Inc.*, 53 S.E.C. 155, 160-61 (1997) (affirming NASD's denial of request to increase associated persons, where the firm failed, *inter alia*, to "institute remedial measures" in response to numerous reneges). The Member Firm failed to do that.

The Member Firm also failed to respond satisfactorily to the legitimate concerns about FINOP A's workload. Although the Member Firm maintains that FINOP A will have the time to manage his FINOP responsibilities, that position was seriously undermined by the Member Firm's own witnesses. The CEO and the Chairman provided testimony that demonstrated a troubling lack of familiarity with a FINOP's duties and responsibilities. *NASD Notice to Members 06-23* (May 2006)—ironically, one of the Member Firm's exhibits—explains that, among other duties, a FINOP, including one who works part-time, and/or off-site, and/or holds registrations with more than one firm, is required to supervise a number of individuals involved with, and functions concerning, the Member Firm's compliance with financial responsibility requirements. Despite this clear guidance, the CEO testified that FINOP A did *not* supervise the person who currently provides to FINOP A the information and data he uses to perform his FINOP responsibilities. The Chairman testified that the person who provides FINOP A with that information does so "underneath FINOP A's direction," but the Chairman evaded saying whether that meant that FINOP A has supervisory responsibilities. Moreover, the CEO testified that the requested changes in the Member Firm's business—both in size and in nature—would not impact FINOP A's role as FINOP. The CEO's view is mistaken.[27] All of this testimony causes us to question whether the Chairman and the CEO appreciate how much time the FINOP role reasonably requires and whether they have properly evaluated whether FINOP A can fulfill the FINOP role part-time, off-site, while working for numerous firms.[28]

For his part, FINOP A testified that he has sufficient time to devote to the Member Firm. Of the Member Firm's witnesses, FINOP A alone recognized that if the Member Firm's application were approved, it would "probably increase" the time he would have to devote to his FINOP role. We do not question that FINOP A believes he could handle the increased workload. FINOP A's mere belief, however, is far from sufficient to meet the Member Firm's burden of

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[27] The CEO subsequently changed his testimony and testified that the growth in the Member Firm's size *would* impact its financial controls system, but that it would be a "graduated impact" because the Member Firm sought only to "grow at a controlled rate." But that does not answer the question of how the Member Firm plans to cope with that growth from a compliance perspective, given these issues, whether the growth is controlled or swift.

[28] The Member Firm's argument that no rule prevents a FINOP from working for multiple firms misses the point. The Member Firm's burden is to demonstrate that it is capable of complying with the financial responsibility rules. A FINOP's workload certainly bears upon that issue.

proof, especially considering his and the Member Firm's past disciplinary history. The Member Firm offered no concrete evidence concerning the amount of time that likely would be required to fulfill the FINOP role and that FINOP A had to devote to the Member Firm, or FINOP A's work experience with firms involved in the amount and nature of retail sales that the Member Firm seeks to do. Contrary to the Member Firm's arguments, it is the Member Firm's burden to provide such evidence, not Member Regulation's. Absent evidence of this nature, the Member Firm has not demonstrated that FINOP A has adequate time to devote to the Member Firm, should the Member Firm's application be approved in full.[29]

For these reasons, we find that the Member Firm failed to demonstrate that it is capable of complying with the financial responsibility rules.

2. The Member Firm Has Failed to Demonstrate that It Is Capable of Complying with Registration Requirements

Of the events that Member Regulation mentioned in its decision that raise a presumption of denial, one concerns a past failure to comply with registration requirements: the Member Firm's 2005 State 4 Stipulation and Consent. Closely related to that, and also raising the rebuttable presumption of denial, is the Supervisor's 2005 State 4 Stipulation and Consent. We find that the Member Firm has failed to rebut the presumption of denial arising from these events.

During the application process before Member Regulation, the Member Firm argued that the violations in the State 4 matters were unintentional, that the Member Firm alerted State 4 to the transaction, and that State 4 subsequently approved the Member Firm to conduct business in that state.[30] The Member Firm's arguments do not persuade us that it has overcome the presumption of denial.

First, the record does not permit us to conclude that the State 4 violations were of little significance. The record does not clearly explain what sanctions were imposed on the Member Firm and the Supervisor. Moreover, the Member Firm's 2005 State 4 Stipulation and Consent was not the first time the Member Firm has been cited for violations of registration requirements.

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[29] The Member Firm also made a number of other arguments that do nothing to help it meet its burden of proof, including that: (1) FINOP A is not precluded from serving as a FINOP; and (2) Member Regulation's decision was the first time NASD has suggested that FINOP A's disciplinary history is problematic. Such arguments do not address how the Member Firm and FINOP A would comply with the financial responsibility rules going forward, notwithstanding their past violations.

[30] In its appeal brief, the Member Firm argued that "the problem . . . is not what the Member Firm did in State 4 . . . but rather one of disclosure" of the State 4 matters on CRD forms. That argument takes too narrow a view of the significance of the State 4 matters, because they raise the rebuttable presumption of denial. Rule 1017(g).

In a letter of caution dated September [ ], 2002 ("the Member Firm's 2002 Letter of Caution"), NASD found that the Member Firm permitted an employee to conduct a securities business while he was inactive for failing to fulfill his continuing education requirements.

In any event, to meet its burden of proof, the Member Firm must do more than explain why a past disciplinary event is minor. As explained above, the Member Firm must explain specifically what steps it will take to ensure that such violations will not occur in the future. The Member Firm has done little in that regard. The Member Firm claims that the State 4 matter "predated our management changes and system/compliance upgrades." The Member Firm does not explain, however, what it was about the prior management and compliance system that allowed the Supervisor's and the Member Firm's violations, and what specifically has changed to ensure that such violations are not repeated. Perhaps the closest the Member Firm comes to addressing its burden is its representation that it "now comprehensively monitor[s] all transactions within states in question before any private transactions are performed." The Member Firm did not explain, however, who was monitoring the transactions or how such monitoring was occurring, nor did it point to any written supervisory procedures that address such issues.

Accordingly, the Member Firm has not met its burden of explaining how it is capable of complying with registration requirements despite the State 4 disciplinary matters.

3. The Member Firm Has Failed to Demonstrate that It Is Capable of Complying with Disclosure Requirements

Separate from the merits of the State 4 disciplinary matters, the Member Firm failed to ensure that information about such matters was disclosed timely on Forms BD and U4. We find that the Member Firm has not demonstrated that it is capable of complying with disclosure requirements.

Article IV, Section 1(c) of NASD's By-Laws requires a member firm to "ensure that its membership application with the NASD is kept current at all times." Likewise, Article V, Section 2(c) of NASD's By-Laws requires that every application for registration as a registered representative "be kept current at all times." Both of these provisions further provide that amendments to Forms BD and U4 shall be filed "not later than 30 days after learning of the facts or circumstances giving rise to the amendment."

On September [ ], 2005, the Member Firm's 2005 State 4 Stipulation and Consent was resolved, an event that the Member Firm was required to disclose on its Form BD. The Member Firm did not update its Form BD, however, until November [ ], 2006, more than one year after the Member Firm was required to do so and only after NASD staff informed the Member Firm of the inaccuracy. Similarly, State 4 securities regulators initiated a disciplinary matter against the Supervisor on May [ ], 2005, and the Supervisor's 2005 State 4 Stipulation and Consent was resolved in September [ ], 2005. Although both events were required to be disclosed within 30 days after each event, the Supervisor's Form U4 did not disclose either event until October [ ], 2006.

The Member Firm concedes that it failed to comply with these disclosure requirements but argues that its failures amounted to an "immaterial administrative oversight." Specifically, the CEO testified that the person who was responsible for making the required CRD updates had left the Member Firm and that, as a result, some updates had not been made. The Member Firm also notes that it promptly amended its Form BD when NASD staff apprised it of the error. These arguments do not persuade us that the Member Firm is capable of complying with NASD disclosure requirements.

First, we disagree that these violations were "immaterial." Maintaining an accurate Form BD serves the key purpose of ensuring that regulators have ready access to the information they need to perform their regulatory responsibilities. Likewise, "a Form U4 serves as a vital screening device for hiring firms and the NASD against individuals with 'suspect history.'" *Dep't of Enforcement v. Taylor*, Complaint No. C8A050027, 2007 NASD Discip. LEXIS 11, at *33 (NAC Feb. 27, 2007) (*quoting Dist. Bus. Conduct Comm. v. Jones*, Complaint No. C02970023, 1998 NASD Discip. LEXIS 60, at *9 (NAC Aug. 7, 1998)); *Respondent 1*, 1998 NASD Discip. LEXIS 63, at *14-22; NASD Membership and Registration IM-1000-1 (providing that an incomplete or inaccurate filing of information that is misleading, or could tend to mislead, with NASD by a registered representative "may be deemed to be conduct inconsistent with just and equitable principles of trade"). Here, the information that the Member Firm failed to disclose was especially material, not just because it was disciplinary history, but because that history raised the rebuttable presumption of denial in this application.

Second, we disagree with the Member Firm's assertion that these disclosure failures resulted from an "oversight." That admission might be acceptable if this was an isolated incident, but it was not. These failures are only two of several examples—one of them quite recent—where the Member Firm or its associated persons failed to properly amend CRD forms:

- The Member Firm's 2002 Letter of Caution cited the Member Firm's failure to ensure that a representative disclose an outside business activity on Form U4.

- The Member Firm's 2005 Letter of Caution cited the Member Firm's failures to disclose timely on Form BD the opening of the Member Firm's City 3 office and a disciplinary action against the Member Firm. It also cited the Member Firm's failure to ensure that an associated person timely disclose on Form U4 that he had been ordered to requalify by examination as a FINOP.

- The Member Firm's 2006 SEC Deficiency Letter cited the Member Firm for failing to ensure that outside business activities were disclosed on a Form U4.

- In June 2006, the Member Firm amended its Form BD to add several business lines that it was not authorized to conduct.

To meet its burden, the Member Firm needed to accept that it has repeatedly violated disclosure requirements and address *how* it will ensure compliance with those requirements upon a full approval of its application. To date, the Member Firm has not done so.

* * * * *

Accordingly, because the Member Firm has failed to demonstrate that it is capable of complying with the financial responsibility, registration, and disclosure rules, we affirm Member Regulation's findings that the Member Firm has not demonstrated that it satisfies Rule 1014(a)(3).

C. Rule 1014(a)(13)

Member Regulation also found that the Member Firm failed to demonstrate that NASD does not possess any information indicating that the Member Firm may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or NASD rules, as required by Rule 1014(a)(13). As explained below, we agree that there are several issues that raise questions about whether the Member Firm would evade complying with federal securities laws and NASD rules.

1. The Member Firm Has Failed to Address Concerns that It Is Permitting Individual A to Serve as an Unregistered Representative or Principal

As explained above, in a Form SB-2/A filing, Firm G represented that "the Member Firm is controlled by Individual A." A failure by the Member Firm to disclose that Individual A is a controlling person, and therefore an unregistered representative or principal, would raise obvious concerns about whether the Member Firm may evade compliance with federal securities laws and NASD rules. *See* Membership and Registration Rules 1021(a), 1031(a) (requiring persons engaged as representatives and principals to register). Such concerns are heightened here, considering that Individual A has recently been ordered to cease and desist from violating the antifraud provisions of the Exchange Act.

The Member Firm has essentially denied that Individual A is, or ever has been, a controlling person of the Member Firm. We are not yet persuaded. Although the Member Firm submitted a letter from Law Firm B, Firm G's law firm, purporting to corroborate the Member Firm's position about Individual A, notably absent from that letter is any explanation about how, or why, the statement in the Firm G filing concerning Individual A was made in the first place. Were the Firm G statement the only indication that Individual A was a controlling person of the Member Firm, we might give the Member Firm's denial more weight. There are other ties, however, between the Member Firm and Individual A that cause us to look upon the Member Firm's position with skepticism. Individual A is a business partner of the Supervisor's at Firm E. The Member Firm's business and business continuity plans explain that: (1) the Member Firm's City 3 office "shares an office with Firm E;"[31] (2) the Member Firm's "merchant banking" services include "providing [Firm E] portfolio companies with growth capital and M&A

[31] After submitting its business plan, the Member Firm subsequently stated that "the [City 3 office] leases a lockable and self contained office within the leasehold space of Firm E []." This description of the office set-up does not alleviate our concerns.

advisory services;" and (3) Firm E contracts for utility services for the City 3 office. In addition, in the Member Firm's 2006 SEC Deficiency Letter, the SEC found that, in June 2004, the Member Firm improperly sent $149,268 in commissions to Firm E.

Contrary to the Member Firm's argument, it is the Member Firm's burden to demonstrate that Individual A is not a controlling person, not Member Regulation's burden to prove that he is. *[CASE REDACTED]* (stating that the applicant "bears the burden of establishing the merits of its application"). We appreciate that proving the negative fact that Individual A is not a controlling person of the Member Firm may be a difficult burden. Nevertheless, the severity of Individual A's recent violations and the need to protect investors requires that the Member Firm do more to demonstrate that Individual A is not a controlling person of the Member Firm. Until the Member Firm does so, the possibility that the Member Firm is permitting Individual A to serve as an undisclosed representative or principal of the Member Firm constitutes information indicating that the Member Firm may circumvent, evade, or otherwise avoid compliance with securities laws or NASD Rules. For this reason, the Member Firm has not demonstrated that it satisfies Rule 1014(a)(13).

2. The Member Firm Has Failed to Demonstrate that the CEO Was not Evading the Requirement to Disclose Accurate Information to NASD Staff

As explained below, the CEO provided incorrect information in response to NASD staff's requests on two occasions, and did so in an evasive manner. The CEO's conduct in this regard amounts to information indicating that the Member Firm may evade compliance with securities laws and NASD rules.

a. The CEO Falsely Denied to NASD Staff that He Had not Conducted a Pre-Hire Screen of Employee A

First, we find that the CEO incorrectly, and evasively, informed NASD staff that he had not conducted, nor remembered conducting, a pre-hire screening of Employee A.

Both the CEO and Compliance Examiner 1 agree that Compliance Examiner 1 asked the CEO whether he had done such a pre-hire screening and that, in response, the CEO said he had not. The CEO further testified that he also told Compliance Examiner 1, "I don't recall doing [a pre-hire screen]" and "if you have something to show that I did it, show me." The Member Firm argues that the CEO's initial response to Compliance Examiner 1 was just an honest mistake.

The Subcommittee, however, was not persuaded that the CEO had simply forgotten about his pre-hire screening of Employee A, for several reasons. First, at the time of the CEO's and Compliance Examiner 1's conversation, which occurred sometime on October [ ], 2006, the pre-hire screen, which occurred on July [ ], 2006, was a fairly recent event. Second, because the Member Firm is a very small firm, the Subcommittee deemed it unlikely that the CEO would not

recall that he had considered hiring Employee A.[32] Third, the record suggests that the CEO was familiar with Employee A before the pre-hire screen because Employee A was the recently departed president of Firm B, of which the CEO also had served as president and remains an indirect owner. Fourth, the CEO had a motive to conceal that he was considering hiring Employee A.[33] For these reasons, as well as its observations of the CEO's demeanor, the Subcommittee did not credit the CEO's testimony that he had simply failed to recall the pre-hire screen. As a result, we find that the Member Firm has failed to demonstrate that the CEO's initial response to NASD staff concerning the pre-hire screen was not evasive of NASD staff's questions.

b. The CEO Falsely Denied to NASD Staff that He Had an Ownership Interest in Firm B

We further find that the CEO falsely denied to NASD staff initially that he had an ownership interest in Firm B.

It is undisputed that the CEO is an indirect owner of Firm B and that, in a telephone conversation that occurred sometime before July [ ], 2006, Compliance Examiner 1 asked the CEO whether he had any ownership interests in a broker-dealer. The CEO and Compliance Examiner 1 dispute, however, whether the CEO denied his ownership interests in that phone conversation.

On this point, the Subcommittee credited Compliance Examiner 1's testimony that the CEO did not disclose his indirect interest in Firm B over the CEO's testimony that he did. The Subcommittee found Compliance Examiner 1 to be credible based on her demeanor, her command of the details of the application, and because, throughout her testimony, she readily acknowledged her own mistakes in her processing of the application, even where such testimony appeared to contradict Member Regulation counsel's litigation strategy. In contrast, the Subcommittee found the CEO not to be credible based on a number of factors, including: (1) that

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[32] Although the CEO acknowledged that it was only a "possibility" he considered hiring Employee A, the preponderance of the evidence demonstrates that that was clearly the reason the CEO conducted the screen. The CEO performed the screen just 10 days after Firm B terminated Employee A, and the Member Firm had in July 2006 hired two other representatives from Firm B. The CEO offered no other possible reason for the screening, and none is evident.

[33] At the time of the pre-hire screen, Employee A's Uniform Termination Notice for Securities Industry Registration ("Form U5") disclosed that he was the subject of an NASD investigation or proceeding. Moreover, 10 days before the pre-hire screen, Employee A was "voluntar[ily]" terminated from Firm B. And less than one month before Compliance Examiner 1's and the CEO's conversation, an NASD Hearing Panel found Employee A liable for aiding and abetting market manipulation, suspended him for 90 days, fined him $5,000, and required him to requalify in all capacities. *[CASE REDACTED]*. That disciplinary action has been called for review and is pending before the NAC.

the CEO did not give credible testimony about his pre-hire screening of Employee A; (2) that the CEO's purported ignorance about Firm D's business or whether it had any other holdings besides Firm B strained credulity, given that the CEO had recently served as the president of both Firm D and Firm B; [34] and (3) its observations of the CEO's demeanor.

We further find that the CEO's conduct in this regard was evasive of NASD's questions. Given the size of his indirect ownership interest in Firm D, that the CEO had been employed by Firm B less than one year prior to NASD staff's question, that Firm D had no other operations besides Firm B, and that, as CEO of a broker-dealer, he should be well aware of his ownership interests in other broker-dealers, it is highly unlikely that the CEO failed to recall his indirect ownership interest when NASD staff asked him about it.

* * * * *

"Providing false or misleading information to NASD is conduct inconsistent with just and equitable principles of trade." *Dep't of Enforcement v. Masceri*, Complaint No. C8A040079, 2006 NASD Discip. LEXIS 29, at *35 (NAC Dec. 18, 2006). As a result, the CEO's two attempts to avoid providing accurate information in response to NASD's questions amounts to information indicating that the Member Firm may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or NASD Rules. For this reason, the Member Firm has not demonstrated that it satisfies Rule 1014(a)(13).

D. Restrictions

The Member Firm argues that the numerical restrictions on associated persons and offices imposed by Member Regulation lacked a reasonable basis. As explained below, we disagree, and we affirm the numerical restrictions on the Member Firm's associated persons and offices. We modify, however, the nature of the associated persons restriction to clarify the types of persons to which that restriction applies. Finally, we remand this proceeding for Member Regulation to permit the Member Firm to file an amended application that would be processed on an expedited basis.

1. The Numerical Restrictions

We find that the numerical restrictions that Member Regulation imposed on the Member Firm—employing no more than 30 associated persons and operating no more than nine offices—are appropriate. Restrictions imposed by Member Regulation on member firms require a "connection to a regulatory purpose." *Domestic Sec., Inc.*, 52 S.E.C. 934, 939 (1996). In light of the Member Firm's failures to satisfy Rule 1014(a)(3) and 1014(a)(13), permitting the Member Firm to grow at a controlled pace is an appropriate way to monitor whether the Member Firm can and will comply with securities laws and NASD rules—especially the financial

[34] A Firm D prospectus filed July [ ], 2006, states that "[o]ther than [the operations of Member Firm B], we do not presently have any material operations."

responsibility, registration, and disclosure requirements—while growing to a larger size and adjusting to a new business model.

In our view, to grant the Member Firm's request in full and allow it to expand from seven to 75 associated persons would be inappropriate at this time. The Member Firm has had difficulty complying with federal securities laws and NASD rules at its current size, let alone 10 times that.[35] As for what would appropriately restrict the Member Firm's growth consistent with our concerns, there is no formula to determine such restrictions. Restricting the Member Firm to 30 associated persons and nine offices, however, is a reasonable check on the Member Firm's growth at this time. The Member Firm provided *pro forma* financial documents in which it projected that it would take one year to expand to a size of 30 representatives. Thus, allowing the Member Firm to employ 30 associated persons permits the Member Firm to pursue its one-year expansion plan. Likewise, permitting the Member Firm to operate nine offices at this time allows for an expansion of a similar size to the permitted expansion of associated persons. These restrictions do not halt the Member Firm's projected path of growth, and they denote a reasonable point—after one year of expansion—when Member Regulation could conduct a meaningful consideration of further expansions.

2. The Nature of the Associated Persons Restriction

While we affirm the numerical restrictions, Member Regulation's decision inaccurately described the types of persons that Member Regulation intended to restrict the Member Firm from employing. The decision described the restriction as follows:

> The Member Firm may employ no more than 30 associated persons (registered and unregistered) who have direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, including the immediate supervisors of such persons.

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[35] As a reference point, the Member Firm's requested expansions are significantly larger than what the "safe harbor" expansions in Membership and Registration IM-1011-1 might have allowed. IM-1011-1 provides that, for a firm that qualifies for the safe harbor provision and employs one to 10 "Associated Persons involved in sales," an expansion of 10 such persons within a one-year period is "presumed not to be a material change in business operations." IM-1011-1 further provides that, for a firm that has one to five offices (registered or unregistered), an expansion of three offices within a one-year period is presumed not to be a material change in business operations. It is not clear on this record whether the Member Firm could have taken advantage of the safe harbor provision, due to the open questions concerning whether Individual A is an unregistered principal of the Member Firm. IM-1011-1 provides that the safe harbor expansions are not available if, among other situations, the SEC has found within the past five years that a principal of the member violated Exchange Act Rule 10b-5.

At the hearing, the CEO complained that this restriction appears to include non-registered administrative and operations personnel as within the permitted 30 associated persons and substantially limits the number of "income producers" the Member Firm could employ. When asked whether Member Regulation intended this restriction to permit employing 30 "registered representatives," Compliance Examiner 1 testified, "[y]es, I believe so."

We agree with the Member Firm that the associated persons restriction is susceptible to being read in a manner that is stricter than necessary and that this ambiguity should be resolved. Therefore, we direct Member Regulation to modify the restriction on associated persons in the Member Firm's restrictive agreement as follows:

> The Member Firm may employ no more than 30 registered representatives who have direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, including the immediate supervisors of such persons.

Our order directing such a modification to the associated persons restriction is not based on Compliance Examiner 1's testimony, but on the NAC's understanding of how this expansion of the Member Firm's business should be approved.[36]

3. Future Application to Modify the Restrictions

There is one reason pertaining to the restrictions for which we see the need to remand the proceeding. The process by which the Member Firm might normally request further expansions may be unduly burdensome under the circumstances. Several of our concerns—such as the Member Firm's failure to show it is capable of complying with the financial responsibility, registration, and disclosure rules, and the CEO's evasive responses to NASD staff—would likely decrease in significance should the Member Firm operate under the terms of the restrictive agreement that it signed on December [ ], 2006, for one year and neither encounter the kinds of compliance problems it has in the past, nor act in a way that raises additional questions about whether the Member Firm would circumvent, evade, or otherwise avoid compliance with securities laws. Likewise, our questions about Individual A would subside if the Member Firm could provide adequate proof that Individual A is not an undisclosed representative or principal of the Member Firm. We also are concerned that the Member Firm may have failed to supply *pro forma* financial documents "reflecting the [requested] change," as required by Rule 1017(b)(2), because Member Regulation specifically asked only for 12-month projections. Because the restrictions are so closely tied to the Member Firm's *pro forma* projections, it is

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[36] The modified restriction shall not be effective until the Member Firm enters into a new membership agreement containing the modified restriction. Member Regulation shall immediately prepare a new membership agreement containing this modified restriction and present it to the Member Firm for its signature.

possible that Member Regulation might have imposed different restrictions had the Member Firm provided *pro forma* documents reflecting the requested change.

For these reasons, and given the admittedly lengthy process that can be triggered by a new membership application, we think it would be unfair to require the Member Firm to file a new membership application should it want to seek in the near future an expansion consistent with its original application. Accordingly, we remand the case, with the following instructions, to permit the Member Firm to file an Amended Application on an expedited basis:

1. Anytime between December [ ], 2007, and February [ ], 2008, the Member Firm may file an amended application to employ up to 75 registered representatives and operate up to 15 branch offices ("Amended Application").

2. The provisions in Rule 1017 shall govern the processing of the Member Firm's Amended Application, unless inconsistent with the procedures set forth herein.

3. Should the Member Firm file an Amended Application, Rule 1017(b) applies as written, except that the Member Firm shall only be required to present: (1) facts showing that the circumstances that gave rise to the restrictions have changed; (2) a statement addressing with specificity why the restrictions should be modified or removed in light of the standards in Rule 1014 and the rationale for the imposition of the restrictions; (3) facts describing the operations since the restrictions were imposed, including any increases in registered representatives or offices; (4) facts describing any change in ownership or control or supervisors and principals since the restrictions were imposed; and (5) *pro forma* financials that fully reflect the requested change.

4. Rule 1017(e) applies as written, except that, unless otherwise agreed, the Member Firm shall file additional information or documents with Member Regulation within 15 days after Member Regulation's request.

5. Rule 1017(g)(3) applies as written, except if Member Regulation fails to serve a decision within 60 days after the filing of an Amended Application or such later date as Member Regulation and the Member Firm have agreed in writing, the Member Firm may file a written request with the NASD Board requesting that the NASD Board direct the Department to issue a decision.

6. If the Member Firm does not file an Amended Application on or before February [ ], 2008, the membership proceeding shall close.

7. If the Member Firm seeks to apply for approval to expand beyond 75 registered representatives and 15 offices, or to engage in any new business activities, the procedures outlined in this decision do not apply.

We emphasize that Rule 1017(g)(1) and (g)(1)(B) would apply as written in processing any such Amended Application. These sections provide that, in rendering a decision on an application

that requests the modification of a membership agreement restriction, Member Regulation shall consider the public interest, the protection of investors, and "whether maintenance of the restriction is appropriate in light of . . . the standards set forth in Rule 1014," among other relevant factors. In processing an Amended Application filed by the Member Firm, Member Regulation is free to consider any and all issues as appropriate under the rules. The issues therefore can include, if appropriate, matters that we have not considered on this appeal because Member Regulation had not given the Member Firm proper notice.

IV. Conclusion

After reviewing the record and the parties' briefs, we affirm Member Regulation's findings that the Member Firm has failed to demonstrate that it would satisfy the standards in Membership and Registration Rule 1014(a)(3) and (13). We affirm the numerical aspect of the restrictions on associated persons and offices imposed by Member Regulation, but we modify the nature of the associated persons restriction to clarify that it restricts only the number of registered representatives that the Member Firm may employ. We also remand the proceeding to allow the Member Firm to file an Amended Application, in a manner consistent with this decision.[37]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

[37] We also have considered and reject without discussion all other arguments advanced by the Member Firm and Member Regulation.