BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of the Association of X as a General Securities Representative with The Sponsoring Firm	Redacted Decision Notice Pursuant to Rule 19h-1 Securities Exchange Act of 1934 Decision No. SD06014 Date: 2006

I. Introduction

On May 15, 2006, the Sponsoring Firm[1] submitted a Membership Continuance Application ("MC-400" or "the Application") with NASD's Department of Registration and Disclosure, seeking to permit X, a person subject to a statutory disqualification, to associate with the Sponsoring Firm as a general securities representative.[2] In June 2006, a subcommittee ("Hearing Panel") of NASD's Statutory Disqualification Committee held a hearing on the matter.[3] X appeared at the hearing, accompanied by his counsel, his proposed supervisor, and

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

[2] A different member firm had previously filed an MC-400 in October 2005 to sponsor X's continued association in the securities industry. X was already employed by that firm when he became statutorily disqualified in September 2005. Since a person who becomes statutorily disqualified while he or she is employed in the securities industry is permitted to remain in the industry until the MC-400 application process has been completed, X continued to work for that firm until April 2006, when it decided to close its retail operation and terminated him. The Sponsoring Firm filed its Application to sponsor X's association in May 2006, but because X had not been employed by the Sponsoring Firm when he became statutorily disqualified, he was not permitted to begin his association with the Sponsoring Firm while the instant MC-400 remained pending.

[3] Pursuant to NASD Procedural Rule 9524(a)(10), the Hearing Panel submitted its written recommendation to the Statutory Disqualification Committee. In turn, the Statutory

[Footnote continued on next page]

the chief compliance officer for the Sponsoring Firm. NASD Employee 1 and NASD Employee 2, Esq. appeared on behalf of NASD's Department of Member Regulation ("Member Regulation").

For the reasons explained below, we approve the Sponsoring Firm's Application.

II. The Statutorily Disqualifying Event

X is statutorily disqualified due to a Final Judgment by Consent ("Court Judgment") entered in September 2005, by the U.S. District Court for State 1[4] and an Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions ("SEC Order") entered in September 2005, by the SEC.[5] Both actions stemmed from an SEC complaint that alleged that X and others participated in a fraudulent "pump-and-dump" manipulation of the penny stock of Company 1. At the time in question, X was President of Firm 1, which allegedly permitted its City 1, State 1 branch office to engage in fraudulent activity with regard to Company 1 transactions. X was specifically cited for approving the opening of the City 1 branch office, authorizing it to solicit transactions in Company 1 stock (even though Firm 1's written supervisory procedures prohibited solicited transactions in penny stocks), and failing to appropriately supervise the personnel in the City 1 branch office in connection with transactions in Company 1 stock.

The Court Judgment permanently enjoined X from violations of the federal antifraud rules, permanently barred X from participating in an offering of penny stock, and fined him $20,000.

The SEC Order barred X from association in a supervisory capacity with any broker or dealer, with the right to reapply for association after two years. Because the Application requests that X be permitted to associate with the Sponsoring Firm as a general securities

---

[cont'd]

Disqualification Committee considered the Hearing Panel's recommendation and presented a written recommendation to the National Adjudicatory Council, in accordance with Procedural Rule 9524(b)(1).

4 *See* Art. III, Sec. 4(h) of NASD's By-Laws (stating that a person is disqualified if he or she is permanently or temporarily enjoined by an order or judgment of "any court of competent jurisdiction" from "engaging in or continuing any conduct or practice . . . in connection with the purchase or sale of any security").

5 *See* Art. III, Sec. 4(b)(1) of NASD's By-Laws (stating that a person is disqualified if he or she is subject to an SEC order "barring . . . such person from being associated with a broker, dealer").

representative, with no supervisory duties, the SEC's supervisory bar does not apply to this application.

III. Background Information

A. X

X first registered in the securities industry as a general securities representative (Series 1)[6] in December 1976. He also qualified as an investment company products/variable contracts principal (Series 26) in April 1981 and a general securities principal (Series 24) in February 1996.

NASD's Central Registration Depository ("CRD"®) shows that X has previously registered with seven other member firms.

X filed for Chapter 7 personal bankruptcy in June 2002 "due to loss of revenues and company [Firm 1] going out of business." X's debts were discharged pursuant to an order of the bankruptcy court dated December [ ], 2002.

1. Prior Disciplinary History

X also has some other disciplinary history. In December 1993, the State 2 Securities Administrator and the State 2 Attorney General entered into a Consent Agreement with X and a former employer that prohibited X from applying for registration in State 2 for one year, fined him $50,000, and prohibited him from receiving commission overrides from State 2 representatives for one year. The civil action that State 2 filed against X, in his role as a supervisor of an office in State 2, his former employer, and others alleged material misrepresentation, non-disclosure of sales commissions, sales of unsuitable investments, and the use of misleading prospectuses in connection with the offering and sales of junk bond mutual funds and periodic payment plans. State 2 subsequently permitted X to register in the state.

In March 1998, the State 3 Division of Securities issued a final order denying X's application for a securities sales license. State 3 based its decision on the findings in the 1993 State 2 Consent Agreement, discussed above. State 3 subsequently permitted X to register.

In November 2000, NASD accepted a Letter of Acceptance, Waiver and Consent ("AWC") from X, finding that he had permitted an inactive registered representative to effect three securities transactions for customers. NASD fined X $3,000.

2. Customer Complaints

---

[6] The Series 1 was the predecessor to the Series 7, the general securities representative qualification examination.

In October 1999, Customer MH filed a complaint naming X in his capacity as a supervisor; Firm 1; and two representatives as respondents. The complaint sought compensatory damages of $135,000 for misrepresentation, unsuitable transactions, breach of fiduciary/contractual duty, and negligence. The complaint went to an arbitration panel, which awarded MH $42,295, jointly and severally, against the respondents in April 2002. X's obligation to pay this award was discharged pursuant to the December 2002 bankruptcy court order.

In September 2000, Customer JO named X and others at Firm 1 in a complaint alleging failure to supervise. In May 2001, the complaint against X was dismissed in its entirety.

B. The Sponsoring Firm

The Sponsoring Firm is based in City 2, State 1. It became an NASD member in July 2005 when it purchased a shell company named Firm 2, a former brokerage firm that had been an NASD member since April 1983. The Sponsoring Firm is a full-service broker-dealer that has three branch offices, two offices of supervisory jurisdiction ("OSJ"), three registered principals, 31 registered representatives, and five other employees.

1. NASD Disciplinary History

a. Firm 2

Firm 2 has some disciplinary history. The record shows that NASD issued Letters of Caution ("LOCs") to Firm 2 following routine examinations in 2000, 2002, and 2004. The 2000 LOC cited Firm 2 for not having provisions in its clearing agreement regarding the handling of customer complaints and the availability of exception reports, and for untimely filing of its annual audit for the fiscal year ending December 1999. NASD did not require Firm 2 to file a written response to this LOC because it had responded to these items in an exit interview.

The 2002 LOC cited Firm 2 for failing to timely report a notice of arbitration and for failing to restrict the duties of a representative who had not complied with continuing education requirements. Again, NASD did not require Firm 2 to file a written response to this LOC because it had responded to these items in an exit interview.

The 2004 LOC cited Firm 2 for several violations, including untimely filing of a disclosure event, failure to report a termination for cause, continuing education requirement violations, and failure to maintain option agreements for two option accounts. Firm 2 responded by letter dated February [ ], 2005, listing the actions it had taken with regard to the deficiencies noted by NASD.

In January 2005, NASD suspended Firm 2 because it had failed to comply with an arbitration award or pay fees in an arbitration case, or to satisfactorily respond to an NASD request to provide information concerning the status of compliance. NASD lifted the suspension in February 2005 when Firm 2 paid the applicable fees.

b. The Sponsoring Firm

NASD issued the Sponsoring Firm an LOC in February 2006, following an alternative municipal examination of the Sponsoring Firm in January 2006. The LOC cited the Sponsoring Firm for failing to file a Form RTRS on a timely basis and failing to timely update its designation of an anti-money laundering compliance officer. The Sponsoring Firm responded by letter dated March [ ], 2006, listing the actions it had taken with regard to the deficiencies noted by NASD.

The record shows no other recent complaints, disciplinary proceedings, or arbitrations against the Sponsoring Firm.

IV. X's Proposed Business Activities and Supervision

The Sponsoring Firm proposes to employ X as an independent contractor, general securities representative. X will work from his home in State 1, which will be designated as a branch office. The Sponsoring Firm will compensate X on a commission basis.

The Sponsoring Firm proposes that the Proposed Supervisor will be X's primary, responsible supervisor and that he will supervise X directly by working from X's home office. The Proposed Supervisor has been employed by the Sponsoring Firm since April 2006. He first registered in the securities industry in September 1995 as a uniform securities agent state law (Series 63) and became registered as a general securities principal in March 2005.

The Proposed Supervisor was previously associated with seven other member firms. Since August 2002, the Proposed Supervisor has been associated with the same firms as X.[7]

The record does not show any disciplinary or regulatory proceedings, complaints, or arbitrations against the Proposed Supervisor.

V. Member Regulation's Recommendation

Member Regulation recommends that the Application be denied because: 1) X has disciplinary history in addition to his statutory disqualification; 2) the Proposed Supervisor is not an experienced supervisor; and 3) the proposed plan of supervision is inadequate, primarily

---

[7] X supervised the Proposed Supervisor at two firms from August 2000 until February 2005. X also supervised the Proposed Supervisor at a third firm from February 2005 until March 2005, when the Proposed Supervisor passed his general securities principal qualification examination. The Proposed Supervisor then became X's supervisor at the third firm until they both left in April 2006 when that firm closed its retail operation.

because it does not address how the Sponsoring Firm will ensure that X complies with the permanent bar against his participation in penny stock offerings.

VI. Discussion

Pursuant to the Commission's controlling decisions in this area, we approve the Sponsoring Firm's Application to employ X as a general securities representative, subject to the supervisory terms and conditions set forth below.

A. The Legal Standards

The legal framework that governs our review is set forth in *Paul Edward Van Dusen*, 47 S.E.C. 668 (1981). *Van Dusen* provides that in situations where the Commission has already addressed an individual's misconduct through its administrative process and has chosen to impose certain sanctions for that misconduct, NASD should not evaluate a statutory disqualification application based solely on the individual's underlying misconduct. The Commission stated that when the period of time specified in its order has passed, in the absence of "new information reflecting adversely on [the applicant's] ability to function in his proposed employment in a manner consonant with the public interest," it is inconsistent with the remedial purposes of the Securities Exchange Act of 1934 ("the Exchange Act") and unfair to deny an application for re-entry. *Van Dusen*, 47 S.E.C. at 671.

The Commission also noted in *Van Dusen*, however, that an applicant's re-entry is not "automatic" after the expiration of a given time period. Instead, the Commission instructed NASD to consider other factors, such as: 1) intervening misconduct in which the applicant may have engaged; 2) the nature and disciplinary history of the prospective employer; and 3) the supervision to be accorded the applicant. *Id.*

B. The *Van Dusen* Analysis Applies to the Application

As we previously noted, the September 2005 SEC Order bars X only in a supervisory capacity for two years. Accordingly, the SEC settlement places no restrictions on X's ability to continue to act as a general securities representative, as long as the firm sponsoring him completes the MC-400 process.

X is disqualified as a result of the earlier September 2005 Court Judgment, which imposed on him a permanent injunction against violations of the federal securities antifraud laws and a permanent bar from participating in an offering of penny stock. Accordingly, we must review the Application as instructed by the Commission in *Van Dusen*.

The Commission has explained that when it institutes an administrative action and imposes a sanction, it considers the public interest based on the individual's past misconduct and the statutorily disqualifying event. *Harry M. Richardson*, Exchange Act Rel. No. 51236, 2005 SEC LEXIS 414, at *8 (Feb. 22, 2005). In spite of X's disciplinary history, which occurred before the 2005 Court Judgment, the Commission determined that X's underlying misconduct as

the supervisor of Firm 1's City 1 branch office warranted a two-year supervisory bar. The Commission did not suspend or bar X in his capacity as a general securities representative.

After applying the *Van Dusen* framework to this matter, we have determined to approve the Application.

1. No Intervening Misconduct

The record shows no complaints, regulatory actions, or criminal charges against X since the SEC considered X's disciplinary history and entered the 2005 SEC Order. Accordingly, pursuant to *Van Dusen* and its progeny, we do not look to X's disciplinary history or the underlying misconduct that led to his statutory disqualification in evaluating the Application. We thus find that the Application meets the first prong of the *Van Dusen* framework because we are not aware that X engaged in any intervening misconduct.

2. No Consideration of a "Pattern of Negligence"

Member Regulation argues that because X has demonstrated a "pattern of negligence" and a "pattern of circumventing established rules and procedures," the Commission's exception to *Van Dusen* should apply. *See Morton Kantrowitz*, Exchange Act Rel. No. 54278, 2006 SEC LEXIS 1784, at *17 (Aug. 7, 2006) (affirming NAC determination that the misconduct underlying Kantrowitz's injunction and subsequent misdemeanor conviction constitutes a "a sufficient pattern of misconduct to make consideration of the earlier statutorily disqualifying event appropriate under *Van Dusen* and *Ross*"). Member Regulation argues that we should base a denial on X's underlying misconduct and the rest of his disciplinary history.

Member Regulation's argument fails because we may not base a finding of a pattern of misconduct on actions that occurred before the Commission settled its administrative case against X in 2005. *See Arthur H. Ross*, 50 S.E.C. 1082, 1084-85 (1992) (stating that analysis of a potential pattern of misconduct only arises when an individual has engaged in misconduct after the statutorily disqualifying event); *see also Richardson*, 2005 SEC LEXIS 414, at *9 (same). Thus, Member Regulation's reasoning is inapposite because all of the other actions filed against X (the 1993 State 2 Consent Agreement, the 1998 State 3 denial of registration order, the 2000 NASD AWC) occurred *prior* to the time when the SEC considered its administrative action against X and imposed the September 2005 order. The Commission therefore had the opportunity to review all of X's history and consider the public interest when it concluded that a two-year supervisory bar would be an appropriate sanction for X's involvement in the Company 1 matter.

3. The Nature and Disciplinary History of the Sponsoring Firm

Next, we consider the nature and disciplinary history of the Sponsoring Firm and whether it will affect the Sponsoring Firm's ability to supervise X and restrict his activities regarding federal securities antifraud laws and penny stock transactions. The Sponsoring Firm, which engages in a general securities business, became an NASD member in July 2005, after it acquired the shell of a former member firm, Firm 2. In February 2006, NASD issued an LOC to the Sponsoring Firm, following an alternative municipal examination. Prior to that time, NASD had issued several LOCs to Firm 2 for deficiencies noted in the routine examinations that NASD conducted in 2000, 2002, and 2004.

We find that the items listed in the LOCs that NASD issued to Firm 2 do not influence our evaluation of the Application. Firm 2 had a different management structure from the Sponsoring Firm, and Firm 2's past disciplinary history does not affect the manner in which the Sponsoring Firm intends to supervise X. Similarly, we find that the Sponsoring Firm's 2006 LOC from NASD regarding certain municipal violations does not indicate a problem with the Sponsoring Firm's ability to supervise individuals. We are also satisfied that the record shows that the Sponsoring Firm has satisfactorily responded to NASD regarding those deficiencies and has made the necessary corrections to its procedures. We therefore conclude that none of the Sponsoring Firm's disciplinary incidents raise concern that it would not be able to effectively supervise X in his proposed responsibilities as a general securities representative, working from his home office.

4. The Sponsoring Firm's Proposed Supervisory Structure for X

Finally, we consider the Sponsoring Firm's proposed supervisory structure for X. We begin by recognizing that the SEC Order contemplated that X could continue to act as a general securities representative, with no required period of suspension.

The Proposed Supervisor has been registered in the securities industry since 1995 and has no disciplinary history. We note that the Proposed Supervisor has only acted as a general securities principal since March 2005, at which time he began supervising X at a prior firm. Prior to that time, from August 2000 until March 2005, X supervised the Proposed Supervisor at three different firms. We also note that the Sponsoring Firm proposes that the Proposed Supervisor will supervise X in his home four days per week from 8:00 a.m. until 5:00 p.m. Although we are troubled by these factors, we acknowledge that the Commission has previously warned that NASD should not interfere with the SEC's ability to settle cases and has instructed NASD to honor the expectations of the settling parties to SEC actions. *Richardson*, 2005 SEC LEXIS 414, at *18 and n.32 ("Although the decision to settle an administrative proceeding is a complex function of multiple factors, the right to reapply for association is often an important aspect of a settlement. Settlement terms should be administered in accordance with the fair expectations of the settling parties."). Thus, given the facts of this matter, and the framework of *Van Dusen*, *Ross*, and *Richardson*, we conclude that the Proposed Supervisor's lack of experience and the Sponsoring Firm's proposed work environment for X do not adversely affect the Sponsoring Firm's ability to effectively supervise X as a general securities representative.

We find that the Sponsoring Firm has demonstrated that its supervisory structure is designed to provide reasonably effective supervision to X as a general securities representative. Without any crippling deficiencies in the Sponsoring Firm's supervisory structure, we cannot deny the Application.

With regard to preventing penny stock transactions, the Sponsoring Firm's heightened supervisory procedures for X specifically state that X "will not engage in the purchase, sale, recommendation or solicitation of penny stocks." Moreover, at the hearing, and in a post-hearing submission dated July [ ], 2006, the Proposed Supervisor 2, the Sponsoring Firm's chief compliance officer, maintained that the Sponsoring Firm has a policy not to permit representatives to solicit the purchase or sale of penny stocks on behalf of a customer. The Sponsoring Firm does, however, permit representatives, at the customer's request, to accommodate the sale of a penny stock from a customer's existing position (which has been transferred into the Sponsoring Firm). Proposed Supervisor 2 emphasized, however, that any such accommodating transaction may occur only with his prior written approval.[8] Thus, Proposed Supervisor 2 stated that X could not effect any penny stock transactions without going through Proposed Supervisor 2, and that he would terminate X immediately if any such activity occurred. These procedures will ensure that X is prevented from participating in penny stock transactions.

In reaching our conclusion as to the Sponsoring Firm's ability to prevent X from participating in penny stock offerings, we also consider X's unopposed testimony that he has never solicited a sale or a purchase of a penny stock for any of his clients in his 30 years in the securities industry. X also testified to the conservative business mix of his customers—375 customers own mutual funds and 90% of them are in tax-free bond funds because they are retirees; 80% of X's mutual fund business is in income-related funds, and 100 clients have Exchange Traded Funds or stocks and some individual bonds; and X has no discretion in customers' accounts, his customers have no options accounts, and only one of his customers is on margin. Moreover, the record shows that the SEC charges that led to X's statutorily disqualified status were not for his own involvement in sales of penny stocks, but for his failure to supervise representatives in Firm 1's City1 branch office with regard to their sales of Company 1.

As to all of X's transactions, the Sponsoring Firm's heightened supervisory procedures provide that both the Proposed Supervisor and the Proposed Supervisor 2 will review, approve, and initial every order ticket for X on a daily basis. When the Proposed Supervisor is not in X's home office, X is prohibited from effecting trades on the computer and must, instead, call them in to the Proposed Supervisor 2 for approval. Accordingly, the Sponsoring Firm will be able to monitor all of X's transactions effectively.

---

[8] The Proposed Supervisor 2 has been employed in the financial services industry since 1993. He became a general securities principal in October 2003, and he has no disciplinary history.

After considering all of the facts, we approve X as a general securities representative with the Sponsoring Firm, supervised by the Proposed Supervisor and the Proposed Supervisor 2, and subject to the following terms and conditions of employment:

1. The Proposed Supervisor and the Proposed Supervisor 2 will review, initial, and date all of X's order tickets on a daily basis;

2. The Proposed Supervisor will review all of X's incoming correspondence daily and will review all of X's outgoing correspondence prior to its being sent. X will print out a daily log of faxes from the fax machine for the Proposed Supervisor to review;

3. The Proposed Supervisor and the Proposed Supervisor 2 will review every new account form for X and, if approved, sign such form;

4. The Proposed Supervisor will be in the office with X at least four times per week from 8:00 a.m. until 5:00 p.m. If the Proposed Supervisor is not in the office, X will be prohibited from effecting trades on the computer, and will, instead, call them in to the Proposed Supervisor 2 for approval;

5. The Proposed Supervisor 2 will make random unannounced office visits to X's home office at least once during each calendar quarter;

6. The Sponsoring Firm will amend its written supervisory procedures to state that the Proposed Supervisor is the primary responsible supervisor for X, and that the Proposed Supervisor 2 is the back-up supervisor;

7. X will provide a list of all sales contacts to the Proposed Supervisor, including the nature of the contacts, on a daily basis;

8. The Proposed Supervisor will review X's written sales contacts and investigate any irregular activity;

9. The Proposed Supervisor 2 will conduct five random telephone calls per quarter to X's customers to verify information or ascertain the customers' level of satisfaction;

10. X will not participate in any manner, directly or indirectly, in the purchase, sale, recommendation, or solicitation of penny stocks (this is defined in the Court Judgment as "any equity security that has a price of less than five dollars, except as provided in Rule 3a5-1 under the Exchange Act [17 C.F.R. 240.3a51-1]");

11. The Proposed Supervisor must certify quarterly (March 31st, June 30th, September 30th, and December 31st) to the Compliance Department that X and the Proposed Supervisor are in compliance with all of the above

conditions of heightened supervision; and

12. For the duration of X's statutory disqualification, the Sponsoring Firm must obtain prior approval from Member Regulation if it wishes to change X's responsible supervisor from the Proposed Supervisor to another person.

NASD certifies that: 1) X meets all applicable requirements for the proposed employment; 2) the Sponsoring Firm represents that it is not a member of any other self-regulatory organization; and 3) the Sponsoring Firm represents that X is not related to the Proposed Supervisor 2 and the Proposed Supervisor by blood or marriage.

VII. Conclusion

Accordingly, in conformity with the provisions of SEC Rule 19h-1, the association of X as a general securities representative with the Sponsoring Firm under the above-referenced supervisory plan will become effective upon the Commission issuing an order that it will not institute proceedings pursuant to Section 15(b) of the Exchange Act and that it will not direct otherwise pursuant to Section 15A(g)(2) of the Exchange Act. This notice shall serve as an application for such an order.

On Behalf of the National Adjudicatory Council,

_____

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary