BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of the Membership Continuance Application of Applicant Firm A	DECISION Application No. 20090173549 Dated: August 18, 2010

FINRA's Department of Member Regulation denied the application of a member firm to change the firm's ownership and control. Held, Member Regulation's decision to deny the firm's application is affirmed.

Appearances

For Applicant Firm A: Consultant 1

For the Department of Member Regulation: FINRA Staff Attorney 1

Decision

Pursuant to NASD Rule 1015(a), Applicant Firm A ("the Firm") appeals a December 2009 decision of FINRA's Department of Member Regulation ("Member Regulation") denying the Firm's application to transfer a 100 percent ownership interest to another FINRA member firm ("the Application").[1] Member Regulation denied the Application because it found that: (1) Applicant Firm A failed to rebut the presumption that it was incapable of complying with the securities laws; and (2) FINRA possessed information indicating that the Firm may circumvent, evade, or otherwise avoid compliance with the securities laws. After conducting a hearing and reviewing the record, we affirm Member Regulation's decision to deny the Application.

[1] NASD Rule 1017(a)(4) requires a member to apply for approval of "a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly controlling 25 percent or more of the equity or partnership capital."

I. Summary of the Evidence

A. The Applicant Firm And Its Associated Persons

1. The Firm

On February 9, 2009, Company 1 a New York limited liability company, entered into a purchase agreement to buy all the issued and outstanding interests of Firm B, a FINRA member firm and New Jersey limited liability company. The purchase price of $100,000 was payable with $20,000 deposited into an escrow account as a good-faith deposit and the balance of $80,000 was due by the closing date of March 16, 2009. In April 2009, Firm B filed a Certificate of Amendment with the New Jersey Division of Revenue, authorizing it to change its name to Applicant Firm A.

The sale of Applicant Firm A was effected on the closing date. Applicant Firm A's business plan stated that it would engage primarily in a general securities business. Under this plan, Applicant Firm A would sell stocks, corporate debt, mutual funds, government securities, municipal securities, annuities, oil and gas interests, options, and private placements to both individuals and institutions. In March 2009, FINRA received notice that Firm B was purchasing Applicant Firm A, subjecting the Firm to FINRA's continuance of membership process. In March 2009, Applicant Firm A submitted the Application.

2. The Firm's Associated Persons

a. Employee 1

Employee 1 became associated with Applicant Firm A as a general securities representative in February 2009. Employee 1 is the Firm's indirect owner. Employee 1's indirect ownership of Applicant Firm A stems from the fact that Company 1 is the 100 percent direct owner of Applicant Firm A, and Employee 1 owns 100 percent of Company 1. Employee 1 became registered with Applicant Firm A as a general securities representative in February 2009. Prior to purchasing Applicant Firm A, from January 2008 to January 2009, Employee 1 was associated with FINRA member firm Company 2 as a general securities representative.

b. Employee 2

Employee 1 hired Employee 2 in March 2009 to be Applicant Firm A's Chief Executive Officer, President, and Chief Compliance Officer ("CCO"). Employee 2 is registered with Applicant Firm A as, among other things, a general securities principal and a general securities representative. At Applicant Firm A, Employee 2 is responsible for supervising Employee 1. Prior to joining Applicant Firm A, from November 2006 to March 2009, he was associated with FINRA member Company 2 as the firm's CCO, where he also supervised Employee 1. Employee 1 had no ownership interest in Company 2.

c. Employee 3

On March 17, 2009, Employee 2 hired Employee 3 to be Applicant Firm A's Financial and Operations Principal ("FINOP"). At the time of the Application, Employee 3 was associated with at least five FINRA members as a part-time FINOP.

B. NASD Rule 1014(a)(3) State Actions Against Applicant Firm A

NASD Rule 1014(a)(3) lists certain "events" that Member Regulation considers when determining whether a membership continuance application should be granted. These events include whether an applicant or its associated persons: (1) had adverse action taken against them by a state; (2) had been the subject of a settled regulatory action by a state; and (3) had heightened supervision imposed on them by a state.[2] The following facts involving persons associated with Applicant Firm A are undisputed:

1. Montana's Settlement with Employee 1

In September 2005, the State of Montana's Auditor's Office Securities Department ("Montana Securities Department") brought an action against Employee 1, alleging several violations of the securities laws, including excessive trading, unsuitable trading, fraud, excessive use of margin loans, offering and selling unregistered securities, and failing to report a customer complaint. In November 2005, Employee 1 settled the action and the Montana Securities Department issued an order ("Montana Order") under which Employee 1 agreed to: (1) pay a $35,000 fine; (2) withdraw his securities registration in Montana; and (3) refrain from applying for a securities license in the state for two years. At the time that Applicant Firm A filed the Application; Employee 1 had reapplied and was registered with the State of Montana.

2. Iowa's, New Jersey's, and Florida's Imposition of Heightened Supervision on Employee 1

On January 4, 2008, Company 2 applied to the State of Iowa Insurance Division, Securities and Regulated Industries Bureau ("Iowa Bureau"), requesting that Employee 1 be allowed to register as a representative of the firm. In February 2008, the Iowa Bureau issued an order ("Iowa Order") approving the request on the condition that Company 2 subject Employee 1 to heightened supervision. The Iowa Order contained specific language stating that both Company 2 and Employee 1 acknowledge that the Iowa Order was a reportable item on Employee 1's Uniform Application for Industry Registration or Transfer ("Form U4"). The Iowa Order also included language that prohibited Employee 1 from acting in a principal capacity at a broker-dealer.

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[2] *See* NASD Rule 1014(a)(3)(A), (C), and (E).

In November 2009, Applicant Firm A informed FINRA that both New Jersey and Florida had subjected Employee 1 to heightened supervision as a condition of his registration with the Firm in those states.[3] In addition, Employee 1 testified that New Jersey and Florida had prohibited him from acting in a principal capacity as a condition of his registration with the Firm in those states.

3. Idaho's Adverse Action Against Employee 1

On August 18, 2008, Employee 2 filed an amended Form U4 with the Central Registration Depository® to register Employee 1 in the State of Idaho as a securities agent for Company 2. In July 2009, the State of Idaho's Department of Finance ("Idaho Finance Department") issued an order ("Idaho Order") stating that Employee 1, while employed at Company 2, violated Idaho Code § 30-14-505, by negligently and without scienter or actual intent, filing a false or misleading Form U4 due to the failure to disclose the Iowa Order. For this misconduct, Employee 1 agreed to withdraw his application for registration and to pay a $1,250 fine. As a result of the Idaho Order, Employee 1 became statutorily disqualified.[4]

4. Idaho's Adverse Action Against Employee 2

As described in the Idaho Order, the Idaho Finance Department found that Employee 2, acting for Company 2, also violated Idaho Code § 30-14-505, by negligently and without scienter or actual intent, filing a false or misleading Form U4 due to his failure to disclose information about the Iowa Order. For this misconduct, the Idaho Finance Department cautioned Employee 2 "to refrain from violating the Idaho Uniform Securities Act and to agree to comply with [the Act] . . . in the future." As a result of this order, Employee 2 also became statutorily disqualified.[5]

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[3] Applicant Firm A was aware of the New Jersey restrictions in or around April 2009, and the Florida restrictions in August 2009.

[4] "Section 604 of the Sarbanes-Oxley Act expanded the definition of statutory disqualification in [Securities] Exchange Act [of 1934 ("Exchange Act")] Section 3(a)(39) by creating and incorporating Exchange Act Section 15(b)(4)(H) so as to include persons that are subject to any final order of a . . . state insurance commission . . . that . . . constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative or deceptive conduct." *FINRA Regulatory Notice 09-19* (June 2009). We follow the state's determination as to whether Employee 1 violated a state law prohibiting fraudulent, manipulative or deceptive conduct ("FMD conduct"). Here, Idaho filed a Uniform Disciplinary Action Reporting Form that indicated Employee 1 had violated a law prohibiting FMD conduct.

[5] *See infra* note 8.

C. Employee 1's Participation at the Firm

Employee 1 testified that he participated in management meetings, met with clients, referred employment candidates to Employee 2, and participated in Applicant Firm A's sales meetings by educating Applicant Firm A's registered representatives about certain private placements. Employee 1 also testified that he planned to introduce potential "strategic partners" to the Firm to participate in investment banking deals.

D. Applicant Firm A's Supervisory Structure

In the Application, Applicant Firm A proposed that Employee 2, whom Employee 1 hired, would supervise Employee 1. Applicant Firm A contended in the Application that Employee 2 could effectively supervise Employee 1, because Employee 2 was a "15-year veteran of the . . . industry with a stellar compliance record." However, at the time of the application, Employee 2 was statutorily disqualified as a result of the Idaho Order.

Employee 2 testified that the Idaho Order was the result of a "clerical error" stemming from his failure to "fully read" the Iowa Order when he sought to register Employee 1 with the State of Idaho. Employee 2 further testified that it was his understanding that, absent specific language in the Iowa Order stating that it was reportable, he was not required to report the order on Employee 1's Form U4.

In September 2009, Member Regulation asked Applicant Firm A to propose a "new supervisory structure for the Firm given the fact that [Employee 2] [had] been statutorily disqualified." Instead, in October 2009, Applicant Firm A proposed the exact same supervisory structure, citing its belief that because FINRA did "not place any restrictions" on Employee 2, he was not statutorily disqualified.[6]

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[6] Employee 2 and Employee 1 qualified for an exception to the requirement that a statutorily disqualified individual must seek FINRA's written approval to associate with a FINRA member Firm by filing an application ("MC-400 application") with FINRA's Department of Registration and Disclosure. *See FINRA Regulatory Notice 09-19* (June 2009) (identifying exceptions to the MC-400 application requirement for statutory disqualifications arising solely from certain orders issued by state agencies). Here, Applicant Firm A mistakenly concluded that Employee 2 was no longer statutorily disqualified because FINRA did not require him to file an MC-400 application to remain associated with the Firm. Employee 2 is, in fact, statutorily disqualified because the Idaho Order was based on a violation of state law that prohibited deceptive conduct. *See* Exchange Act 15(b)(4)(H)(ii).

E. Applicant Firm A's Rebuttal Evidence

On November 2, 2009, Member Regulation informed Applicant Firm A that Employee 1 was statutorily disqualified. Citing NASD Rule 1014(a)(3)(A), Member Regulation gave the Applicant Firm An opportunity to "rebut the presumption" that its Application should be denied as a result of Employee 1's statutory disqualification.[7] On November 9, 2009, Applicant Firm A responded by informing Member Regulation that Employee 1 "had his statutory disqualification reduced . . . [and that][t]here were no restrictions of any kind placed on Employee 1 from FINRA."[8]

On November 16, 2009, Member Regulation asked Applicant Firm A to "put in place a supervisory system to ensure that Employee 1 is effectively being subjected to [heightened supervision]," citing its concern that Employee 1 owned Applicant Firm A and Employee 2 reported to Employee 1. To that effect, Member Regulation asked Applicant Firm A to provide a "detailed description of how Employee 2's supervision (sic) responsibilities would be reviewed, particularly in light of the fact that Employee 2 also simultaneously functions as the Firm's CCO." In addition, Member Regulation asked Applicant Firm A to identify a principal who could review Employee 2's supervision of Employee 1.

In its November 2009 response, Applicant Firm A again cited Employee 2's 15 years of experience and stellar record—with the exception of a "clerical error" that led to the Idaho Order—as proof that Employee 2 would effectively supervise Employee 1.[9] Applicant Firm A also argued that Employee 1 would not interfere with Employee 2's duties as CCO. Finally, Applicant Firm A stated that Employee 3 was a principal who could review "the documentation produced by Employee 2 in regard with (sic) the heightened supervision [of Employee 1] implemented by the [F]irm and also document this review."[10]

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7 *See infra* Part III.A.

8 As with Employee 2, Applicant Firm A mistakenly believed that because Employee 1 was eligible for one of the exceptions detailed in *FINRA Regulatory Notice 09-19*, he was no longer statutorily disqualified.

9 Applicant Firm A also cited several mitigating factors to support its rebuttal, including that: (1) Idaho did not ban Employee 1 from registering; (2) Montana allowed Employee 1 to register; (3) Employee 1 had not been subject to any unpaid arbitration awards; (4) Employee 1 was never terminated for cause; (5) the New Jersey and Florida requests for heightened supervision of Employee 1 was not specifically tailored to his misconduct; (6) New Jersey and Florida did not ask Employee 1 to withdraw his registration; and (7) no state or federal authority had provided information indicating that Employee 1 posed a threat to the public.

10 In the Application, Applicant Firm A also proposed that Employee 3 would perform a bi-monthly review of Employee 2's supervisory activities regarding Employee 1. The Application

[Footnote continued on next page]

II. NAC Hearing

In March 2010, a subcommittee ("Subcommittee") of the National Adjudicatory Council ("NAC") held a hearing to review Member Regulation's decision to deny the Application. At the hearing, Applicant Firm A submitted 14 exhibits and presented three witnesses: (1) Employee 1; (2) Employee 2; and (3) a FINRA Associate Principal Examiner. Member Regulation submitted 17 exhibits and presented two witnesses: (1) Counsel for FINRA's Department of Disclosure; and (2) a FINRA Associate District Director.[11] The Subcommittee closed the record in March 2010, and the parties presented closing arguments to the Subcommittee by a conference call held in April 2010.[12]

III. The NAC's Review of Issues on Appeal

"An applicant for a change in ownership 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 [NASD] Rule 1014(a)."[13] On appeal, we evaluate

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did not, however, indicate how the Firm would document these activities, or whether such documentation would be segregated for future review by FINRA. After Member Regulation denied the Application, Applicant Firm A proposed that Employee 4 would provide additional supervisory support for Employee 2. The information regarding Employee 4's potential supervisory role at the Firm was therefore not part of the Application process and we do not consider it in our review. *See* NASD Rule 1015(e).

[11] The Subcommittee hearing this case determined to admit all of Applicant Firm A's and Member Regulation's proposed exhibits for the purposes of the hearing and to accord them whatever weight it later determined to be necessary. We adopt the Subcommittee's ruling as our own.

[12] Member Regulation filed a Motion to Reopen the Record and Submit Additional Evidence to rebut claims made by Applicant Firm A at the March 2009 hearing that the Firm had not been the subject of any customer complaints since it became an operational broker. The Subcommittee denied this motion. We adopt the Subcommittee's ruling. As noted above, we limit our review to evidence relating to Member Regulation's decision to deny the Application process, and do not consider information submitted by the parties after the Application was denied.

[13] *Homeland Fin. Servs. Group, Inc.*, Application No. A8A050063, 2006 NASD Discip. LEXIS 23, at *32 (NASD NAC Aug. 10, 2006) (citing *Sierra Nev. Sec., Inc.*, Complaint No. M01970005, 1998 NASD Discip. LEXIS 24, at *14-15 (NASD NAC May 11, 1998), *aff'd*, 54 S.E.C. 112 (1992).

whether Applicant Firm A: (1) rebutted the presumption that it was incapable of complying with the federal securities laws; and (2) proposed a supervisory structure sufficient to ensure that the Firm would not circumvent, evade, or otherwise avoid compliance with the federal securities laws.

The events that triggered the presumption of denial are not in dispute. Thus, on appeal, the critical issue that we consider is whether the Firm rebutted the presumption that the Application should be denied. After conducting a hearing and reviewing the record, we find that Applicant Firm A failed to rebut the presumption and thus failed to meet the membership standards of NASD Rule 1014(a)(3). As discussed below, we also affirm Member Regulation's findings that Applicant Firm A failed to meet the membership standards of NASD Rule 1014(a)(13) by failing to propose an adequate supervisory structure.

IV. Member Regulation's Decision to Deny the Application

A. The Adverse Actions by State Agencies Created a Presumption of Denial

Member Regulation's decision to deny the Application was guided by NASD Rule 1017(g)(1), which states that:

> In rendering a decision on an application submitted under Rule 1017(a), [Member Regulation] shall consider whether the Applicant and its Associated Persons meet each of the standards in Rule 1014(a). Where [Member Regulation] determines that the Applicant or its Associated Persons are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), *a presumption exists that the application should be denied.*

(emphasis added.)

Thus, reading NASD Rules 1017(g)(1) and 1014 together creates a presumption that a membership continuance application should be denied if, among other things, a firm has associated persons who have: (1) been subject to an adverse action by a state; (2) settled a regulatory action with a state; or (3) been placed on heightened supervision by a state. *See* NASD Rule 1014(a)(3)(A), (C), and (E).

The presumption that an application should be denied, however, may be rebutted by the applicant. *NASD Notice to Members 04-10* (Feb. 2004) ("It is [FINRA's] view that, when the applicant or its associated persons have experienced an event enumerated within [Rule 1014] as raising a question of capacity to comply with the [securities laws], it should result in a *rebuttable presumption* to deny the application.") (emphasis added). FINRA has acknowledged that "[a]n applicant may overcome the presumption by demonstrating . . . that it can meet each of the standards in [NASD Rule 1014], notwithstanding the existence of the event(s) of concern." *Id.*; *see also* NASD Rule 1017(g)(1)(A) (stating that "[i]n rendering a decision on an application for approval of a change in ownership or control . . . [Member Regulation] shall determine if the

applicant would continue to meet the standards of [NASD Rule 1014] upon approval of the application").

In its review of the Application, Member Regulation determined that there was a presumption that the Application should be denied after considering the following key events: (1) the State of Idaho had taken adverse action against Employee 1; (2) Employee 1 had settled a regulatory action with the State of Montana; (3) the State of Idaho had taken adverse action against Employee 2; and (4) the States of Iowa, New Jersey, and Florida had subjected Employee 1 to heightened supervision. Member Regulation then examined whether, despite these events, the Firm had rebutted the presumption that the Application should be denied by demonstrating that it could still meet the standards of NASD Rule 1014.

B. Applicant Firm A Failed to Rebut the Presumption that the Application Should Be Denied

1. Employee 1 Was Actively Engaged in the Firm's Activities

In the Application, Applicant Firm A asserts that Member Regulation placed undue emphasis on Employee 1's role at the Firm. Specifically, Applicant Firm A claims that Employee 1's ownership of 100 percent of Applicant Firm A is not important because Employee 1 is a passive investor in the Firm and Employee 2 was capable of supervising Employee 1 in this limited role.[14] The record does not support either of these assertions.

FINRA Notice to Members 04-10 suggests that a membership continuance application should be denied when a broker-dealer or a person associated with the broker-dealer has "a disciplinary history of some concern" and "the influence of [the] associated person on the [broker-dealer] is not appropriately restricted by [the broker-dealer's] supervisory structures and procedures." Here, Employee 1's disciplinary history was significant, including essentially a two-year suspension from engaging in securities activities in Montana, and a failure to report the Iowa Order, which he had acknowledged was reportable on a Form U4 only six months earlier.

Despite this significant disciplinary history, however, Employee 1's influence on Applicant Firm A is substantial. For example, Employee 1 owned 100 percent of Applicant Firm A through Company 1. Moreover, Employee 1 not only participated in management meetings, met with clients, and had some influence regarding hiring decisions (including the hiring of his own proposed supervisor), but he also contributed to Applicant Firm A's sales meetings and planned to play a primary role in bringing in investment banking deals to the Firm. Under these circumstances, extra protections would be required to appropriately restrict Employee 1's influence at the Firm. We find that such protections did not exist at Applicant Firm A.

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[14] Applicant Firm A claims that Employee 1 role's at the Firm would be to serve as a registered representative who does limited equity transactions and mostly works with accredited investors in investment banking products.

2. Applicant Firm A's Supervisory Structure Did Not Meet FINRA's Membership Standards

In its rebuttal, Applicant Firm A did not propose improvements to the Firm's supervisory structure that would shield it against future disclosure problems—the same problems that triggered the presumption of denial under NASD Rule 1014(a)(3). Instead, the Firm focused on several facts that had no bearing on how the Firm could improve its supervisory structure. Applicant Firm A thus did very little to address how the Firm could adequately supervise Employee 1 in light of the unique challenges presented by: (1) the requirement that Employee 1 be placed under heightened supervision; and (2) his new status as the Firm's owner. On the whole, Applicant Firm A's rebuttal merely maintained that the status quo was sufficient. We therefore find that Applicant Firm A did not rebut the presumption of a denial under NASD Rule 1014(a)(3).

In its decision denying the Application, Member Regulation stated that it was concerned with "the fact the [Idaho disclosure problem] arose directly from Employee 2's duties as they related to Employee 1's registration, and in this Application, Employee 2 will continue to have those and other responsibilities." We share this concern. Although Applicant Firm A characterizes Employee 2's disclosure problems as a one-time "clerical error," Employee 2's failure to disclose critical information resurfaced on multiple occasions in the Application process. For example, Employee 2 failed to inform Member Regulation that both he and Employee 1 were subject to statutory disqualification. In addition, Employee 2 allowed several months to pass before informing Member Regulation that New Jersey and Florida had subjected Employee 1 to heightened supervision as a condition of his registration with those two states. Moreover, Employee 2's testimony illustrated that despite all of his years of experience, he still was not fully aware of his obligations to disclose certain reportable events on Employee 1's Form U4.

Employee 2 testified that he believed the Iowa Order was only reportable on the Form U4 because of the specific language in the order designating it as such. The Iowa Order, however, is a reportable event on the Form U4, even without this language. Specifically, Question 14(d)(1)(E) on the Form U4 asks whether "any state regulatory agency has denied, suspended, or revoked your registration or license, *or otherwise by order . . . restricted your activities*." (emphasis added.) The Iowa Order explicitly restricted Employee 1's activities by subjecting him to heightened supervision and prohibiting him from acting in a principal capacity, and is therefore reportable on the Form U4. When this was pointed out to Employee 2 during the hearing, he contended that the reporting requirement was not triggered because Employee 1 had not been planning to engage in the restricted activities anyway. This response reflects a fundamental misunderstanding of FINRA's disclosure requirements.

The record thus shows that Employee 2 had a pattern of failing to make full disclosures, particularly with respect to Employee 1's regulatory issues, and was still unfamiliar with his disclosure responsibilities as a supervisor. Absent additional protections or internal controls, which are not here, we find that Applicant Firm A's supervisory structure is inadequate. In

reaching this finding, we have considered that the Firm has proposed maintaining an almost identical supervisory structure that was in place during prior violations even though Employee 1, as the Firm's new owner, now has a greater ability to evade Employee 2's efforts to supervise him.[15] Under these facts, we conclude that Applicant Firm A did not meet the membership standards of NASD Rule 1014(a)(13).

V. Conclusion

After reviewing the record and considering the parties' arguments, we affirm Member Regulation's findings that Applicant Firm A failed to demonstrate that it would satisfy the standards for membership contained in NASD Rule 1014(a)(3) and (13). We therefore affirm Member Regulation's denial of the Application.[16]

On Behalf of the National Adjudicatory Council,

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Marcia E. Asquith, Senior Vice President and Corporate Secretary

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[15] We do not find that Applicant Firm A's proposal that Employee 3 would perform a bi-monthly review of Employee 2's supervisory activities was sufficient to address our supervisory concerns. The Firm provided no details about how Employee 3 would document and verify this review. It was also unclear, because of Employee 3's other part-time FINOP commitments, whether he would even work on site. We find that greater controls would be needed for the Firm to meet FINRA's membership requirements.

[16] We have considered and reject without discussion all other arguments raised by the parties.