

BEFORE THE NATIONAL ADJUDICATORY COUNCIL
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of the
Membership Continuance Application of
The Firm

DECISION

Dated: September 29, 2014

Department of Member Regulation denied member firm's application to change ownership and control. Held, denial affirmed.

Appearances

For Applicant Firm ("the Firm"): Consultants 1 and 2

For FINRA's Department of Member Regulation: FINRA Staff Attorney 1 and 2

Decision

On July 10, 2012, the Firm filed a continuing membership application that requested FINRA approve a prior transfer of the firm's ownership and control.¹ The Department of Member Regulation ("Member Regulation") issued a decision denying the application on June 21, 2013, after it found that the Firm failed to meet each of the standards for membership established under NASD Rule 1017(h) and set forth in NASD Rule 1014(a). Subsequently, on July 13, 2013, the Firm filed a written request that we review Member Regulation's decision under NASD Rule 1015(a). After conducting a hearing and reviewing the record, we affirm Member Regulation's decision to deny the firm's application.

¹ NASD Rule 1017(a)(4) requires FINRA members to file an application for approval of any "change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital."

I. Background

A. The Firm's Predecessor

The Firm's Predecessor became a FINRA member in June 2001.² In September 2011, the Firm's Predecessor's co-owners agreed to sell the entirety of their interests to the Firm's parent ("Parent") for \$55,000. The sale became effective in November 2011, and the Firm's Predecessor was renamed as the Firm.

B. Parent

Parent, the sole owner of the Firm, is itself 100 percent owned by Owner ("Owner"), who serves as that entity's chief executive officer and managing director. Owner entered the securities industry in 1995, became associated with the Firm as a general securities representative in September 2011, and registered as a general securities principal in November 2011.³ Prior to Parent's purchase of the Firm's Predecessor, Owner was associated with several other firms.

C. The Firm's Application

1. The Firm's Initial Application

On October 7, 2011, the Firm filed with FINRA a continuing membership application seeking Member Regulation's approval of the sale of the Firm's Predecessor to Parent.⁴ This initial application lapsed on June 12, 2012, because the Firm failed to timely respond to a May 4, 2012 request for information (the fourth such request) issued by Member Regulation in connection with the application.⁵

2. The Firm's July 10, 2012 Application

On July 10, 2012, the Firm filed a second application for approval of the firm's change in

² The firm's membership agreement approved it to engage in the private placement of securities.

³ Owner is also the sole owner of Adviser, a registered investment adviser and affiliate of the Firm. Owner is affiliated with several other related entities.

⁴ NASD Rule 1017(c) requires a member to file an application for approval of a change in ownership or control at least 30 days prior to such change.

⁵ NASD Rule 1012(b)(1)(A) provides that a continuing membership application filed pursuant to NASD Rule 1017 shall lapse if an applicant fails to respond fully to a request for information within 30 days.

ownership and control, the denial of which is the subject of our review. The July 10, 2012 application indicated that, as a result of Parent's purchase of the Firm, Owner would oversee the Firm's operations and the Firm's chief compliance officer ("the Firm's CCO") would serve in that position. Although X initially served as the Firm's chief executive officer, Y replaced X as the Firm's chief executive officer in October 2012. Several months later, Y also assumed the Firm's CCO's duties as chief compliance officer because the Firm's CCO failed to pass the investment banking representative examination (which he admittedly needed to serve as the firm's chief compliance officer given its business). The Firm's application stated that, if FINRA approved the firm's change in ownership, all employees would report to Y, "with supervisory and administrative support from" Owner.⁶ The application further stated that the Firm's CCO and the Firm's Financial and Operations Principal ("FINOP"), would act in supervisory capacities.

In the application, the Firm stated it would continue to participate in private placements and "primarily market to high net worth accredited investors, corporate clients and institutional investors." The Firm's most recent business plan indicates that it has offices in City 1, City 2, and City 3.⁷

D. Member Regulation Imposes Interim Restrictions

Shortly after the Firm filed its July 10, 2012 application, Member Regulation imposed upon the Firm interim restrictions under NASD Rule 1017.⁸ Member Regulation memorialized the interim restrictions in an August 15, 2012 letter to the Firm that stated the restrictions were being imposed because Member Regulation "lacks sufficient information at this stage of the application review process to determine whether the Firm meets each standard . . . in NASD Rule 1014, including but not limited to subsections (a)(1), (a)(3), (a)(9), (a)(10), and (a)(13)." Member Regulation further stated that its concerns stemmed, in part, from an SEC investigation of Owner and Adviser.⁹ Member Regulation's interim restrictions prohibited the Firm from: (1)

⁶ At the hearing, the Firm represented that Y recently resigned and that a new chief executive officer has assumed Y's responsibilities as the Firm's chief executive officer and chief compliance officer.

⁷ It appears that Y was the sole Firm employee in the City 2 office. Given his departure, it is unclear whether the Firm intends to continue to operate from this location.

⁸ Under NASD Rule 1017(c), a member may effect a change in ownership or control prior to the conclusion of a continuing membership application proceeding, but Member Regulation may impose interim restrictions upon the member based on the standards in NASD Rule 1014, pending Member Regulation's final action.

⁹ The record shows that Owner and Adviser were the subject of a March 2011 SEC subpoena, and that Owner gave on-the-record testimony to the SEC in March 2012. The record further shows that the SEC was examining whether Adviser had overstated its assets under management, and also whether certain bonds held by a fund included in Adviser's assets under

permitting Owner to act in a principal or supervisory capacity; (2) adding any new lines of business, offices, or personnel; and (3) conducting a securities business on behalf of any affiliated entity owned or controlled by Owner.

At Owner's request, and as discussed more fully below, Member Regulation modified the interim restrictions on October 18, 2012, to permit certain limited activities notwithstanding the interim restriction's prohibition on Owner acting as a supervisor or principal and prohibition on adding new personnel.

E. Member Regulation Denies the Firm's Application

On June 21, 2013, Member Regulation denied the Firm's July 10, 2012 application. Member Regulation based its denial on several factors.

First, Member Regulation found that Owner violated the terms of the interim restrictions that Member Regulation imposed upon the Firm by acting in a principal or supervisory capacity. Specifically, Member Regulation found that Owner signed off on eight of the Firm's client engagement agreements from September 2012 through mid-March 2013. Member Regulation also found that Owner actively negotiated at least one of these engagement agreements, played an integral role in hiring Y as the Firm's new chief executive officer, and reviewed the Firm's CCO's outside brokerage accounts. Member Regulation concluded that, because Owner and the Firm failed to comply with the interim restrictions, it possessed information that the Firm may circumvent, evade, or otherwise avoid compliance with federal securities laws, rules and regulations, and FINRA's rules, and thus the firm did not satisfy NASD Rule 1014(a)(13). Based on these same findings, Member Regulation also concluded that the Firm's supervisory and compliance infrastructure did not prevent violations of FINRA's rules, and thus the Firm did not satisfy NASD Rule 1014(a)(10).

Second, Member Regulation found that, despite numerous requests for information, the Firm failed to: fully explain the terms of an expense sharing agreement between the Firm and Parent; provide a copy of an agreement between the Firm and a technology provider; and keep the Application current by informing Member Regulation of Owner's role with the Firm. Member Regulation found that the July 10, 2012 application thus was not complete and accurate, and the Firm did not satisfy NASD Rule 1014(a)(1). Member Regulation further found that the firm failed to ensure that its contractual or other arrangements were consistent with applicable regulatory requirements, and thus did not satisfy NASD Rule 1014(a)(4).

Finally, Member Regulation found deficiencies in the Firm's written supervisory procedures ("WSPs"). Member Regulation thus concluded that the Firm did not demonstrate

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management were fraudulent. As of the date of the hearing, the SEC has not taken any action against Adviser or Owner in connection with this matter.

that it has an adequate supervisory system and structure for its proposed securities business, and did not satisfy the standard of NASD Rule 1014(a)(9).

F. The Firm Requests a Review of Member Regulation's Decision

On July 13, 2013, the Firm filed a written request that we review Member Regulation's denial of its July 10, 2012 application. On May 20 and 21, 2014, a subcommittee ("Subcommittee") of the National Adjudicatory Council ("NAC") empaneled to hear this matter held a hearing at which the Firm submitted 70 exhibits and presented three witnesses: (1) Owner; (2) the Firm's CCO; and (3) Y.¹⁰ Member Regulation submitted 24 exhibits (with numerous sub-exhibits) and presented two witnesses: (1) FINRA Examiner ("Examiner"); and (2) FINRA Director ("Director").

II. Discussion

NASD Rule 1017(h) provides that, in considering an application for a change in ownership, Member Regulation shall consider the application, the membership interview, other information and documents provided by applicant or obtained by Member Regulation, the public interest, and the protection of investors. *See* NASD Rule 1017(h)(1). An applicant seeking approval of a change in ownership that does not involve modification of a membership agreement restriction must demonstrate that it and its associated persons would continue to satisfy each of the standards set forth in NASD Rule 1014(a). *See* NASD Rule 1017(h)(1)(A). The applicant bears the burden of establishing that it satisfies, and will continue to satisfy, each

¹⁰ Prior to the hearing, the Firm's counsel advised the Subcommittee that he intended to present at the hearing the testimony of an unnamed expert witness and asserted that, as long as he timely disclosed such individual pursuant to NASD Rule 1015(f)(3), the Firm could present such testimony. The Firm's counsel informed the Subcommittee that the Subcommittee would benefit from expert testimony on the issue of whether Owner acted as a principal and "testimony on the accepted standard and industry practice" as to what a principal does. Member Regulation opposed the proposed expert's testimony on several grounds. The Subcommittee excluded the testimony of the Firm's unnamed proposed expert witness. It further held that, based upon the parties' filings, the Firm did not demonstrate that expert testimony was necessary to help illuminate whether Owner acted in a principal capacity. We agree with the Subcommittee's exclusion of this proposed expert testimony, and adopt this ruling as our own. The Subcommittee had discretion to exclude this testimony, and applicant did not adequately explain how the scope of the proposed expert's testimony was anything other than a legal issue or would otherwise aid the Subcommittee in its deliberations. *See Dep't of Enforcement v. Padilla*, Complaint No. 2006005786501, 2012 FINRA Discip. LEXIS 46, at *23 (FINRA NAC Aug. 1, 2012) (affirming hearing panel's exclusion of expert testimony and finding that hearing panel has broad discretion to exclude expert testimony); *Dep't of Enforcement v. Fiero*, Complaint No. CAF980002, 2002 NASD Discip. LEXIS 16, at *89-90 (NASD NAC Oct. 28, 2002) (finding that hearing panel members in FINRA proceedings often have industry experience and affirming exclusion of expert testimony involving legal conclusions).

of the 14 standards for membership approval contained in NASD Rule 1014(a). *See 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 (1999)).

On appeal, we evaluate whether: (1) Owner violated the interim restrictions by acting in a principal or supervisory capacity; (2) the Firm provided a complete and accurate application; (3) the Firm's expense sharing agreement is consistent with applicable regulatory requirements; and (4) the Firm has an adequate supervisory system and structure for its proposed securities business. We find that the Firm has failed to carry its burden to demonstrate that it has satisfied all 14 standards set forth in NASD Rule 1014(a). Consequently, we affirm Member Regulation's decision to deny the application.

A. Owner Violated the Interim Restrictions by Acting in a Principal or Supervisory Capacity

The majority of the parties' arguments, as well as witness testimony, centered on whether Owner violated the interim restrictions by acting in a principal or supervisory capacity. Member Regulation argues that he did and that the Firm thus has not satisfied the standards for membership under NASD Rules 1014(a)(13) and (a)(10).

The Firm disputes this conclusion. It argues that, while Owner may have signed eight agreements with third parties after Member Regulation imposed the interim restrictions, those agreements required the approval of the Firm's chief executive officer before they could bind the firm. The Firm also argues that Owner may have negotiated "tentative" terms of an engagement, but the chief executive officer had to approve such terms before they bound the firm. Further, the Firm does not dispute that Owner hired Y, but it argues that Member Regulation was aware that the Firm needed to find a replacement chief executive officer and "[w]ho but Owner could have accomplished [hiring the chief executive officer] on behalf of the Firm, given that Owner was the source of the Firm's capital." Finally, the Firm disputes that Owner acted in a supervisory or principal capacity because he conducted reviews of the Firm's CCO's outside brokerage accounts. The firm argues that Owner conducted such reviews on behalf of Adviser, not on behalf of the Firm.

For the reasons set forth below, we find that the preponderance of the evidence shows that Owner violated the interim restrictions and that the Firm failed to satisfy the standards set forth in NASD Rules 1014(a)(13) and (a)(10).

1. Evidence

a. The Interim Restrictions

Member Regulation staff imposed upon the Firm the interim restrictions pursuant to NASD Rule 1017 on August 15, 2012.¹¹ Member Regulation prohibited Owner from, among other things, acting in a principal or supervisory capacity and from hiring new personnel.

Owner testified that he found the interim restrictions confusing because “it was never [his] intention to act as a principal from the onset.” Owner testified that he viewed acting as a principal, and as a supervisor, as the same thing, and that the interim restrictions merely prohibited him from supervising the investment banking business of others. Owner further stated that he had concerns about the hiring freeze imposed by the interim restrictions and, more importantly, that someone other than himself would have “control of the company’s checkbook.”

Consequently, on August 20, 2012, Owner requested that Member Regulation clarify and modify the interim restrictions. Owner, a consultant he hired to assist with the continuing membership application, and Member Regulation staff (including Examiner) met to discuss the Firm’s modification request on September 25, 2012. Owner testified that the meeting’s purpose was to clarify the limits imposed by the interim restrictions, explain his concerns regarding financial controls and the hiring freeze, and to “get clarity that this interim restriction on me as a principal really just affected supervision.” Owner testified that he informed Member Regulation staff that, although the Firm did not currently need to hire additional salespeople, it was important to have the ability to hire individuals working in a supporting role. He also testified that he “was very clear . . . in asking does this impact my ability to engage as an investment banker sales and marketing,” and Owner testified that, when he asked whether the interim restrictions only affected his ability to supervise other people, Member Regulation replied affirmatively. Owner testified that, at the end of the meeting, he understood that the interim restrictions prohibited him from acting as a supervisor. Owner further testified that his

¹¹ At the hearing, the Firm argued that Member Regulation improperly imposed the interim restrictions based upon Owner’s failure to disclose the SEC’s investigation of Adviser. The Firm argued, among other things, that Owner was not required to disclose this matter because neither Owner nor the Firm were the subject of the SEC’s inquiries, and because this matter never rose to the level of an “investigation” as that term is defined in the Uniform Application for Securities Industry Registration or Transfer (“Form U4”).

We disagree. Although NASD Rule 1017(c) allows a member to effectuate a change in ownership prior to the conclusion of a membership proceeding, it also broadly permits Member Regulation to impose interim restrictions upon an applicant changing ownership based upon the standards set forth in NASD Rule 1014. As Member Regulation argued at the hearing, its ability to impose such restrictions is a powerful tool for FINRA to limit activities of a firm while an application is reviewed. Here, Member Regulation tied its reasons for imposing the interim restrictions, in part, to the SEC’s investigation. Member Regulation appropriately imposed the interim restrictions based upon the existence of the SEC’s investigation, regardless of whether Owner or the Firm was required to disclose it and regardless of whether it was the primary reason for imposing such restrictions. Moreover, Member Regulation also based its imposition of the interim restrictions on at least two reasons unrelated to the SEC investigation or Owner’s failure to disclose it.

understanding was reinforced when he received Member Regulation's October 18, 2012 letter modifying the restrictions.

Examiner testified that, at the September 25, 2012 meeting, Owner indicated that the Firm would like to hire additional compliance, support, and administrative personnel and Owner requested that he be allowed "to have some type of financial control over the broker-dealer" because the Firm was capitalized with his money. Examiner further testified that, at the meeting's conclusion, Member Regulation informed Owner that staff would review the information and get back to him. Examiner also testified that neither she nor any other staff member at the meeting informed Owner that the only thing he could not do under the interim restrictions was supervise others.

On October 18, 2012, Member Regulation amended the interim restrictions to permit Owner to engage in the following limited activities: (1) "Owner is permitted to act in a limited capacity with respect to supporting the following financial functions of [the Firm]: invoice approval, payment of bills/corporate expenses, check writing, personal contributions of operating capital to [the Firm], and oversight of corporate budgeting. Such supporting role would be subject to the oversight of [the Firm's FINOP];" and (2) the Firm was permitted to add two additional operational support personnel, provided that they would not serve in any type of marketing, sales, or business development capacity. Member Regulation explicitly informed the Firm and Owner that, other than these amendments to the interim restrictions, the restrictions "shall remain, in full force and effect, pending final FINRA action" on the Application.

b. The Firm Engagement Agreements

The record contains eight agreements between the Firm and various entities through which the Firm agreed to provide certain investment banking services. Owner signed each agreement. He signed some of the agreements as "Chairman" of the Firm, others as "Managing Director," and still others as the Firm's "Senior Managing Director." Owner executed one of the eight agreements as the Firm CEO.¹² Owner executed the agreements between September 21, 2012, and mid-March 2013. It is undisputed that Owner also negotiated the terms of the engagement agreements and the terms of at least one other agreement that was never consummated.

The record also contains one-page, "New Business Memos" signed by Y in connection with five of the eight engagement agreements and a memo signed by X in connection with two other engagement agreements authorizing the engagement to proceed and for Owner to sign the engagement agreement.¹³ The New Business Memos contain brief descriptions of the proposed

¹² Owner claimed that this was a typo, and he testified that the counterparties to each engagement agreement "knew that I was not the CEO, or they knew that there was always someone that I was going back to have a discussion with about getting approval."

¹³ The record does not contain an approval memo for one of the engagement agreements. Owner testified that X never memorialized his approval in connection with this agreement

client, engagement, the deal team, and general contact information. The memos signed by X simply grant Owner approval to proceed with the engagement. All of the memos predate the engagement agreements, in some instances by several weeks.

Owner testified that it is customary for boutique investment banking firms to have vice presidents and managing directors developing business, structuring transactions, and negotiating with clients, regardless of whether they are licensed as principals. Owner stated that he signed all eight of the engagement agreements at issue because “they were all transactions that [he] originated and sourced.” He further testified that X or Y, as the Firm’s chief executive officer, approved each transaction and the “on-boarding of the client” prior to the execution of each agreement, although he conceded that the Firm incurred performance liability under each agreement as a result of his signature. Owner testified that, after approval from the Firm’s chief executive officer, he could address any issues that arose. Owner could not recall who drafted the approval memos, when exactly the Firm’s chief executive officer was provided with a copy of the engagement agreement, or whether they were reviewed before Owner signed them. Owner testified that he did not believe he was violating the interim restrictions by executing the engagement agreements on behalf of the Firm because X or Y supervised him and approved the process. Owner also believed that acting in a principal capacity, and thus the restrictions imposed upon him by the interim restrictions, related solely to his supervision of others at the firm (which he asserts that he did not do).¹⁴

Y also testified concerning his approval of six of the eight engagement agreements. Y testified that he completed the New Business Memos based upon the team’s due diligence, and that once he signed off on the approval memo Owner could “get the engagement working.” Y never sent the New Business Memos he signed to Owner, and kept them in a file in City 2. Y testified that he reviewed the engagement agreement after it was signed, although it was unclear from Y’s testimony whether he also reviewed each engagement agreement prior to Owner signing it. Y believed that Owner’s execution of the agreements did not constitute Owner acting as a principal because Y, not Owner, approved the transaction for the Firm. At the hearing, Y reiterated his belief that it is acceptable as a compliance practice for an individual who is not registered as a principal to bind the Firm to a contract.

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because the Firm was “never actually engaged even though a document was signed.” Member Regulation staff testified that the Firm did not provide the engagement agreements in connection with its application. Rather, Member Regulation obtained these documents in connection with an examination of the Firm conducted in March or April 2013.

¹⁴ Owner compared signing the engagement agreements to a registered representative signing forms when opening a new account on behalf of a customer.

c. Owner Hired the Firm's Chief Executive Officer

Owner testified that in July or August 2012, X informed Owner that he wanted to retire as the Firm's chief executive officer. The parties do not dispute that Y replaced X as the Firm's chief executive officer sometime in early October 2012. The parties also do not dispute that Owner played an active role in hiring Y, and the record contains an employment agreement for Y executed by Owner on behalf of the Firm dated October 1, 2012.¹⁵ Owner testified that he did not understand how anyone, other than him, as the Firm's sole owner, could hire Y.

d. Reviewing Outside Brokerage Accounts

The record contains account statements for the Firm's CCO's outside brokerage account from June 2012 through December 2012.¹⁶ Owner reviewed each statement, and he evidenced his review by initialing the account statements. No other initials appear on the statements. The record also contains a memo dated October 25, 2013, from the Firm's CCO to FINRA that states: "due to the affiliation between the RIA and the Firm for the period referenced it was determined to be unnecessary and redundant to duplicate the review of my personal account statements." Further, the record contains a letter dated October 22, 2013, from Y to the Firm's CCO, stating that Y had reviewed his account statements "and they are fine."

Owner testified that all of Adviser's representatives are required to have their outside brokerage accounts reviewed by Adviser. He further testified that because the Firm's CCO could not review his own accounts, Owner reviewed them on behalf of Adviser. Owner also testified that although the Firm's CCO initially believed a review of the account statements by both the Firm and Adviser was redundant, the Firm's CCO decided to have someone from the broker-dealer review them as well. Owner believed Y (and previously, X) may have reviewed the Firm's CCO's brokerage accounts on behalf of the Firm. Owner testified that reviewing outside brokerage accounts is a supervisory responsibility, and stated that he did not review any other representative's account statements.

¹⁵ The parties dispute exactly when Y executed the employment agreement. Owner testified that although the agreement is dated October 1, 2012, it was not signed on that date and "was dated October 1st just to be retroactive." Owner also testified that he called Examiner to ensure that changing the Firm's chief executive officer would not negatively impact the Application, and the record shows that Owner and Examiner spoke on October 5, 2012. Y also testified that the date on his employment agreement is incorrect, and he signed the agreement when the Firm filed his Form U4 on or about October 8, 2012. Member Regulation argues that when Owner spoke with Examiner on October 5, he had already hired Y, which shows that Owner was not being forthright with Member Regulation. We address these arguments in note 21, *infra*.

¹⁶ The Firm produced these account statements in connection with FINRA's 2013 examination.

The Firm's CCO also testified that he considered a review of his account statements by both the Firm and Adviser to be redundant, but sometime after FINRA questioned the Firm concerning this practice, "we pulled all of my outside account statements, and we sent them to Y for his review. That was at a later date." Y also testified that FINRA's 2013 examination caused him to start reviewing the Firm's CCO's account statements on behalf of the Firm, although he later testified that he had been reviewing the Firm's CCO's account statements since joining the Firm in October 2012.

2. Owner Violated the Interim Restrictions

We find that Owner acted in a principal and supervisory capacity, in violation of the interim restrictions. Consequently, we find that the Firm has not satisfied NASD Rules 1014(a)(13) and (a)(10).

NASD Rule 1014(a)(13) requires Member Regulation to consider whether it "possess[es] 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." NASD Rule 1014(a)(10) requires that an applicant demonstrate that it has a supervisory system designed to prevent and detect violations of the federal securities laws, the rules and regulations thereunder, and FINRA's rules, and directs Member Regulation to consider a number of enumerated factors, including "any other condition that will have a material impact on the Applicant's ability to detect and prevent violations." See NASD Rule 1014(a)(10)(J).

NASD Rule 1021(b) defines a "principal" as persons in certain listed categories who are "actively engaged in the management of the member's investment banking or securities business, including supervision, solicitation, conduct of business, or the training of [associated] persons."¹⁷ Persons who do not fall into one of the listed categories in NASD Rule 1021 are nonetheless principals "where . . . the requirement of active engagement in the management of the member's investment banking or securities business is satisfied." *Dennis Todd Lloyd Gordon*, Exchange Act Release No. 57655, 2008 SEC LEXIS 819, at *25 n.31 (Apr. 11, 2008); *Leslie A. Arouh*, Exchange Act Release No. 62898, 2010 SEC LEXIS 2977, at *28 (Sept. 13, 2010) (holding that individuals who are actively engaged in the management of a firm's investment banking or securities business are principals, regardless of their title). In determining whether an individual acted in a principal capacity, "we consider all of the relevant facts and circumstances, including the cumulation of individual acts that might not, on their own, show management." *Gordon*, 2008 SEC LEXIS 819, at *32.

¹⁷ The five listed categories in NASD Rule 1021(b) are sole proprietor, officer, partner, branch manager of an Office of Supervisory Jurisdiction, and director. "Investment banking or securities business" means "the business, carried on by a broker [or] dealer . . . of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others." FINRA By-Laws Art. I(u).

We have previously found that executing and negotiating contracts on behalf of a firm may demonstrate that an individual is acting in a principal capacity. *See, e.g., Dep't of Enforcement v. Harvest Capital Inv., LLC*, Complaint No. 2005001305701, 2008 FINRA Discip. LEXIS 45, at *12-13, 24-33 (FINRA NAC Oct. 6, 2008) (finding that firm's owner acted as a principal by executing several commission sharing agreements on behalf of the firm and by contacting third parties concerning potential contracts with the firm, representing that he had authority to discuss such matters on the firm's behalf); *see also L.H. Alton & Co.*, 53 S.E.C. 1118, 1125-26 (1999) (holding that "[c]ompleting and executing documents obligating the firm to participate in a securities underwriting are clearly among those duties to be performed by a 'principal' enumerated in NASD Membership and Registration Rule 1021(b)"), *aff'd*, 229 F.3d 1156 (9th Cir. 2000).

We have also found that an individual who actively engages in hiring and recruiting firm personnel may be acting in a principal capacity. *See, e.g., Dep't of Enforcement v. Gallagher*, Complaint No. 2008011701203, 2012 FINRA Discip. LEXIS 61, at *8 (FINRA NAC Dec. 12, 2012) (holding that individual acted a principal where he, among other things, recruited, hired and fired key firm employees); *see also Gordon*, 2008 SEC LEXIS 819, at *11, *28-29 (holding that individual acted as a principal when he, among other things, exercised authority over the recruiting, hiring and firing of firm personnel); *Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at *49-50 (June 29, 2007) (finding that individual was actively involved in hiring by recommending the firm hire a branch office manager and two registered representatives).

Moreover, reviewing a registered representative's outside brokerage accounts indicates that an individual is acting in a principal or supervisory capacity. *See, e.g., Gordon Kerr*, 54 S.E.C. 930, 932-34 (2000) (finding that an individual who reviewed trade tickets and new account forms was acting in a principal capacity).

We find that Owner violated the interim restrictions by executing the engagement agreements and negotiating the terms of the agreements, hiring Y as the Firm's chief executive officer, and reviewing the Firm's CCO's outside brokerage accounts. First, we are troubled by Owner's narrow interpretation of what constitutes an activity of a registered principal.¹⁸ Indeed, Owner's narrow view that the interim restrictions merely prohibited him from supervising others

¹⁸ This is particularly true given that Owner was registered as a general securities principal. *See, e.g., Harry Friedman*, Exchange Act Release No. 64486, 2011 SEC LEXIS 1699, at *30 (May 13, 2011) (finding respondent's industry experience to be aggravating); *Dep't of Enforcement v. Cooper*, Complaint No. C04050014, 2007 NASD Discip. LEXIS 15, at *16 (NASD NAC May 7, 2007) (finding that Cooper's status as a principal was aggravating). The same reasoning applies to Y, who ostensibly served as Owner's supervisor and the Firm's chief compliance officer. Moreover, Y testified that Owner did not show him a copy of the interim restrictions, and Owner simply told him that "there were certain restrictions . . . with the CMA and that part of the reason to even bring me in was once we are past that we could start really growing the firm."

is not supported by the record or the text of NASD Rule 1021. The express terms of the interim restrictions prohibit Owner from acting “in any principal and/or supervisory capacity.” The October 18, 2012 modifications to the Interim Restrictions do not support Owner’s view that he was only prohibited from acting as a supervisor, and Examiner credibly testified that no one told him at the September 25, 2012 meeting (or at any other time) that the interim restrictions were so limited.

Second, we find that Owner acted as a principal by executing and negotiating the terms of the engagement agreements. It is undisputed that Owner bound the Firm each time he executed an agreement. Even if X or Y approved the basic terms of each engagement agreement, as well as each draft engagement agreement before it was executed by Owner and each client (which is not clear from the record), Owner could still be acting in a principal capacity notwithstanding that he was acting with his supervisor’s approval.¹⁹ See *Kerr*, 54 S.E.C. at 934 n.7 (rejecting argument that individual did not violate SEC order barring him as a principal because he was supervised); cf. *Gallagher*, 2012 FINRA Discip. LEXIS 61, at *10 (rejecting Gallagher’s argument, in defense of his misconduct, that there were other principals at the firm at the time he improperly acted in a principal capacity and stating that “[t]he presence of other general securities principals at Vision Securities has no bearing on Gallagher’s activities at the firm.”). Indeed, where, as here, Owner executed agreements on behalf of the Firm, which committed the firm to certain contractual terms, he did in fact act as a principal. The Firm’s argument that it is

¹⁹ In August 2014, Member Regulation moved to reopen the record to introduce a transcript from an on-the-record interview of X taken by FINRA’s Department of Enforcement in May 2014, and transcripts from on-the-record interviews of Y taken in November 2012 and June 2014. Member Regulation asserts that X’s on-the-record interview undercuts Owner’s testimony before the Subcommittee that X supervised him and approved Owner’s negotiating and executing engagement agreements. Member Regulation further asserts that Y’s on-the-record interviews show that his testimony before the Subcommittee concerning when Owner offered Y the job of chief executive officer, and Owner’s role at the firm, was not credible. The Firm objected on several grounds, and it argued that FINRA’s Office of General Counsel should decide Member Regulation’s motion to avoid prejudicing the Subcommittee.

We reject the Firm’s argument concerning any potential prejudice to the Subcommittee in reviewing the motion. See, e.g., *Dist. Bus. Conduct Comm. v. Custable*, Complaint No. C8A910006, 1992 NASD Discip. LEXIS 94, at *59 (NASD NBCC Apr. 21, 1992) (holding that adjudicators in NASD adjudicatory proceedings are “capable of disregarding information” that they should not consider), *aff’d*, 51 S.E.C. 643 (1993); NASD Rule 1015(f)(3). However, because we find that Owner acted as a principal regardless of whether X or Y granted Owner prior approval to execute engagement agreements (which is unclear from the record irrespective of any new evidence), we have not considered the proposed transcript of X in connection with this decision. Similarly, and because the precise date of Y job offer is not relevant to our findings, we have not considered the proposed transcripts of Y. See *infra*, note 21. Finally, with respect to the November 2012 transcript, we find that such evidence is untimely and Member Regulation has not demonstrated good cause for previously failing to introduce this document. We exclude it from the record.

commonplace in the industry for non-principals to execute engagement agreements for investment banking services, even if true, does not exonerate Owner. *See Charles E. Kautz*, 52 S.E.C. 730, 733 (1996) (holding that it is no defense that others in the industry are also acting improperly).

Third, we find that Owner acted as a principal when he hired Y as the Firm's chief executive officer.²⁰ Owner argues that as the sole owner of the Firm, logic and practicality dictated that only he could hire Y. We have previously found, however, that owners of firms may violate NASD Rule 1021 when they hire individuals. *See, e.g., Gallagher*, 2012 FINRA Discip. LEXIS 61, at *7; *Harvest Capital*, 2008 FINRA Discip. LEXIS 45, at *4; *see also Kirk A. Knapp*, 50 S.E.C. 858, at 858-59 (1992) (finding that unregistered principal who owned substantially all of firm failed to comply with a principal bar when, among other things, he hired at least one individual). Further, regardless of whether Owner perceived the interim restrictions as illogical and impractical, he and the Firm were obligated to comply with their terms. *See id.* at 862-63 (recognizing that while FINRA may have "created a difficult supervisory situation by imposing a bar as principal on Knapp while permitting him to retain control of the firm and act as a registered representative," the firm was still required to ensure Knapp's compliance with FINRA's bar).

We also reject the Firm's arguments that Member Regulation knew that the firm needed to replace X as its chief executive officer, which exonerates any violation of the interim restrictions. The record shows that while Member Regulation may have known generally that the Firm needed to replace X, the timing of that knowledge in relation to Y's actual hire date is unclear. More importantly, Examiner credibly testified that Owner did not inform her that he was personally and actively involved in hiring Y. Regardless, Member Regulation's failure to act upon this knowledge does not exonerate Owner, and the Firm and Owner cannot shift to FINRA their responsibility to comply with FINRA rules. *See W.N. Whelen & Co.*, 50 S.E.C. 282, 284 (1990) (finding that FINRA's failure to take early action in connection with a violative practice does not operate as an estoppel against later action or cure such violation); *Dep't of Enforcement v. Mission Sec. Corp.*, Complaint No. 2006003738501, 2010 FINRA Discip. LEXIS 1, at *24-25 (FINRA NAC Feb. 24, 2010) (holding that a registered representative cannot shift blame to FINRA for complying with FINRA rules), *aff'd*, Exchange Act Release No. 63453, 2010 SEC LEXIS 4053 (Dec. 7, 2010).

²⁰ In its denial letter, Member Regulation asserted that Owner hired Y as the Firm's chief executive officer, in violation of the interim restrictions. At the hearing, Member regulation asserted that Owner hired a total of four individuals in violation of the interim restrictions. Owner testified that with respect to one of the additional individuals identified by Member Regulation, the Firm hired him as a registered representative. Owner testified that he signed that individual's independent representative agreement on behalf of the Firm, although Y ultimately approved his hire. We find that Owner's execution of this additional agreement further demonstrates that he violated the interim restrictions.

Finally, we find that Owner acted in a principal and supervisory capacity when he reviewed the Firm's CCO's outside brokerage accounts. Owner does not dispute that such activity constitutes a supervisory activity; rather, Owner and the Firm assert that Owner performed his review of the Firm's CCO's brokerage account statements solely on behalf of Adviser. The record, however, does not support this position. Owner and the Firm's CCO testified that because the Firm's CCO deemed it redundant for someone to review the statements on behalf of the Firm, Owner reviewed these documents in 2012. Owner's initials are the only initials that appear on the statements, and given the documents in the record we do not credit Y's testimony that he reviewed the Firm's CCO's account statement beginning in October 2012. Given the close relationship between the Firm and Adviser, and Owner's ownership and control of both entities, we find that Owner effectively reviewed the Firm's CCO's account statements on behalf of both entities in 2012 (which both entities' supervisory procedures required), in violation of the interim restrictions.²¹

* * *

²¹ Member Regulation argues that Owner acted in bad faith by intentionally acting in various ways as a principal and supervisor, while he continued to engage with Member Regulation concerning the interim restrictions and sought to have them modified. The Firm and Owner argue that they were candid and forthright with Member Regulation at every point of the application process and hid nothing from Member Regulation. While the record is unclear whether Owner acted in bad faith and intentionally violated the terms of the interim restrictions, Owner's interpretation of the interim restrictions was, at best, unreasonable under the circumstances.

We also find that the record does not show that Owner was at all times completely forthright in his disclosures to Member Regulation. For example, on the same day Owner met with Member Regulation staff to discuss amending the interim restrictions (including his desire to have flexibility to hire additional personnel), Owner also met with Y to discuss potential job opportunities at the Firm. Owner, however, did not disclose to Member Regulation that he was actively talking to Y or involved in hiring the Firm's chief executive officer. And when he eventually informed Member Regulation that X would be replaced on October 5, 2012, Owner still did not inform Member Regulation that he was personally and actively involved in Y's hiring process. Further, as part of the application process the Firm did not provide Member Regulation with the eight engagement agreements signed by Owner, inform Member Regulation that Owner was actively negotiating and executing engagement agreements on behalf of the Firm, or inform Member Regulation that Owner had been reviewing the Firm's CCO's outside brokerage accounts. Rather, Member Regulation only discovered that Owner was engaging in these activities as a result of a 2013 examination of the Firm. Finally, the record shows that Owner did not initially disclose that the SEC was investigating Adviser, his wholly owned investment adviser. Although the Firm argues that Owner technically was not required to disclose this investigation, Owner's failure to do so—regardless of whether he was required to disclose this matter—undercuts Owner's argument that he was as forthright and open with Member Regulation as he claims.

Whether viewed individually or cumulatively, we find that Owner violated the terms of the interim restrictions by engaging in various activities as a principal or supervisor. Consequently, we find that Member Regulation possesses information indicating that the Firm and Owner may circumvent, evade, or otherwise avoid compliance with FINRA's rules (and thus The Firm has not satisfied NASD Rule 1014(a)(13)). We further find that because Owner violated the interim restrictions while supervised by X and Y pursuant to the Firm's supervisory systems and controls, and because the Firm was prohibited from permitting Owner to act as a principal or supervisor under the interim restrictions, the Firm has not satisfied NASD Rule 1014(a)(10) and has failed to demonstrate that it has a supervisory system designed to prevent and detect violations of FINRA's rules.

B. The Application Was Incomplete and the Expense Sharing Agreement Was Deficient

NASD Rule 1014(a)(1) requires Member Regulation to consider whether a continuing membership application and its supporting documentation are complete and accurate. NASD Rule 1014(a)(4) requires that an applicant demonstrate that it has established all contractual or other arrangements and business relations necessary to comply with the federal securities laws, the rules and regulations thereunder, and FINRA's rules. "[A]n expense agreement must enumerate the services or products being provided to the broker/dealer, with a reasonable cost assigned to each." *NASD Notice to Members 03-63*, 2003 NASD LEXIS 76, at *6 (Oct. 28, 2003).

Member Regulation found that the Firm failed to submit a complete and accurate application because its response to Member Regulation's April 12, 2013 request for information (and its responses to Member Regulation's previous four requests for information in connection with the July 10, 2012 application) was incomplete. Specifically, Member Regulation's denial states that the Firm did not clearly indicate what items were included under "general and administrative expenses" pursuant to the expense sharing agreement between the Firm and Parent, did not clarify what other additional expenses that would be included in the phrase "copiers, printers, fax, office supplies, telephone system, etc.," (and thus submitted an incomplete application), and also failed to demonstrate that the expense sharing agreement complied with FINRA's rules. Member Regulation also found that the Firm did not provide an agreement between the firm and a technology provider²² and that the application did not accurately describe Owner's role at the firm as a principal and supervisor.

²² This document was relevant because the firm indicated that Y would be using technology to remotely discharge his supervisory duties at the firm, and Member Regulation requested all of the firm's contracts with vendors that would assist Y in this regard. In the Firm's response to FINRA dated May 10, 2013, it erroneously stated that a copy of the service agreement was attached. In its appeal, the Firm stated that the alleged missing agreement between the firm and a technology provider had actually been provided to Member Regulation, although it was included in a mislabeled folder. And, at the hearing, the Firm stated that the agreement did not exist because it did not have a direct agreement with the technology provider but rather it utilized the services of this provider through a third party. Owner, however, testified that he could not

The record shows that Member Regulation asked the Firm, on numerous occasions, to clarify and revise the expense sharing agreement to comply with Notice to Members 03-63. The most recent expense sharing agreement submitted by the Firm, dated May 1, 2013, provides that Parent “shall be responsible for the payment of all general and administrative expenses incurred by [the Firm], with the exception of commissions due to registered representatives earned from securities transactions.” The agreement further states that “[e]xpenses shall be calculated on a monthly basis . . . as outlined in Exhibit A.” Exhibit A provides that the Firm shall pay Parent a monthly fee of \$1,300 for office space and “\$200 to cover the proportionate share of all copiers, printers, fax, office supplies, telephone system, etc. on a minimum flat rate basis.”

The Firm responded to some, but not all, of Member Regulation’s requests regarding the expense sharing agreement. It is undisputed that the final expense sharing agreement did not clarify what expenses were included within “general and administrative expenses,” and did not specify what was included in “etc.” The Firm argues that, because Parent assumed the obligation to pay all general and administrative expenses, there was no need to explain what those expenses are comprised of. The Firm also argues that it is reasonable to infer that “etc.,” when viewed in light of the words preceding it, “refers to expenses of the same ilk.”²³ We disagree. Examiner testified that specificity in the agreement regarding what expenses constituted general and administrative expenses was important to ensure that the broker-dealer is accurately reflecting its liabilities, and that use of the phrase “etc.” was too vague. Director likewise testified that a compliant expense sharing agreement is important to ensure that a firm is adequately capitalized, and that understanding the full scope of expenses to be borne by each party is crucial to determine whether a third party has the financial wherewithal to pay such expenses. Indeed, at the hearing Owner testified that “etc.” could include items of greater expense (such as computer systems and Bloomberg terminals). We find that the Firm failed to fully and accurately respond to Member Regulation’s requests for information, and that the expense sharing agreement failed to comply with FINRA’s rules.²⁴

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recall whether he ever informed FINRA that the agreement did not exist, and the record does not show that the Firm adequately responded to FINRA’s inquiry on this matter.

²³ The Firm states that Member Regulation did not mention specific deficiencies in the expense sharing agreement in its April 12, 2013 request, and argues that Member Regulation’s failure to mention these deficiencies in its final request suggests that staff “had no further issues with those amendments” and to claim so now is unfair. The record, however, shows that Member Regulation’s April 12, 2013 request for information did ask for amendments to the expense sharing agreement, including to specify what items are included under “general and administrative expenses” and to specify what “etc.” includes.

²⁴ If Member Regulation’s sole basis for denial had been based upon the Firm’s deficient expense sharing agreement and its incomplete responses regarding that agreement, we might agree that Member Regulation was not reasonable to deny the application and that such deficiencies could be easily remedied. Member Regulation’s denial, however, was also based

[Footnote continued on next page]

C. The Firm's Supervisory Structure and WSPs

NASD Rule 1014(a)(9) requires Member Regulation to consider whether an applicant “has compliance, supervisory, operational, and internal control practices and standards that are consistent with practices and standards regularly employed in the investment banking or securities business, taking into account the nature and scope of Applicant’s proposed business.”

Member Regulation found that the Firm’s WSPs failed to articulate how the designated supervisor would evidence his review in connection with FINRA Rule 2090 (Know Your Customer) and failed to address the frequency with which suitability reviews would be conducted, or how such reviews would be evidenced, pursuant to FINRA Rule 2111. Member Regulation further found that the WSPs contained a disclaimer regarding these rules, stating “[a]t this time these procedures due [sic] not correspond with the Firm authorized business lines.” Member Regulation further noted that the Firm’s WSPs contain actual procedures alongside this implementation disclaimer for a number of activities for which the Firm is not approved, which “create a risk of confusion on the part of those charged with utilizing and abiding by” the WSPs.

The record shows that, with respect to the section of the Firm’s WSPs related to private placements (the only business in which the firm engages), the designated principal will review all private placements and offerings “to ensure that such transactions are conducted within compliance of suitability issues” on a transactional basis.²⁵ The WSPs in this section do not specifically describe how the designated principal will evidence his review. The record also shows that, in the section titled “Customer Transactions” the WSPs do not immediately specify the frequency with which the designated supervisor will review customer transactions or how the supervisor will evidence such review. A later provision in that section, however, entitled “Review of Customer Transactions,” does specify how often the supervisor will review transactions (daily) and how he will evidence such review (initialing each order ticket). Examiner testified that the WSPs appeared to be boilerplate.

We find that the WSPs did not clearly, adequately, and consistently articulate the frequency with which suitability reviews of private placement and offering transactions would be

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upon Owner’s violation of the interim restrictions and the Firm’s deficient WSPs. Further, as described more fully below, the Firm had ample opportunity to respond to Member Regulation’s requests and revise its expense sharing agreement, but it failed to do so.

²⁵ The Firm disputed that the implementation disclaimers contained in the WSPs exempted the firm from complying with suitability and know your customer rules, and argued that these disclaimers did not confuse anyone and were included in the WSPs for continuity purposes. Regardless, the record does not show that Member Regulation asked the Firm to remove these implementation disclaimers, which would have remedied Member Regulation’s concerns in this area. Thus, we do not base our denial on the Firm’s inclusion of the implementation disclaimers.

conducted. Review of the suitability of private placements on a “transactional” basis does not clearly set forth when precisely such review will occur. Further, the WSPs did not clarify precisely how the designated supervisor will evidence his suitability review.

D. The Firm’s Arguments Regarding Deficiencies with Expense Sharing Agreement and WSPs

The Firm argues generally that, even if several deficiencies in the Firm’s responses remained in April 2013, they are immaterial and easily remedied. For example, the Firm argues that it can easily fix the expense sharing agreement and the Firm’s WSPs to address Member Regulation’s concerns, and that the NAC should remand the application to Member Regulation, with instructions, and permit the Firm to remedy these issues.

The Firm, however, ignores that Owner violated the interim restrictions in various ways (which by itself warrants denial of the application and cannot be remedied via a remand). Moreover, the record shows that the Firm had more than ample opportunity to adequately respond to Member Regulation’s numerous requests for information and remedy the deficiencies noted. Member Regulation staff testified that, despite repeated requests and responses, including those related to the Firm’s initial application that lapsed, the application still contained numerous deficiencies and there were multiple inconsistencies with the documents submitted by the Firm. Owner admits that there were issues in the Firm’s responsiveness to Member Regulation’s requests related to the initial application (which Owner partially attributed to the Firm’s consultant), and that the Firm “wasn’t paying attention to the details” during the application process. While we have previously stated that the membership application process “allows for some flexibility,” and an applicant can attempt to satisfy Member Regulation’s concerns with responses that “hone an application to demonstrate that [a member] can operate in a manner consistent with the public interest and the protection of investors,” this does not require Member Regulation to continue making repeated requests where an applicant repeatedly fails to adequately respond. *See In the Matter of the New Membership Application of Member Firm*, Application No. 20090196759, at 12 (FINRA NAC Dec. 2010) (redacted decision), *available at* <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/nacdecisions/p125380.pdf>.

Indeed, Member Regulation warned the Firm in February 2013, after it had already issued to the Firm numerous requests for information, that Member Regulation was contemplating denial of the firm’s application. Owner testified that Member Regulation informed him that it was “unhappy with the back and forth of the communication and they felt we weren’t answering the questions and we weren’t being responsive and that there was still a list of information that hadn’t been provided.” Owner further testified that he requested “one more chance to basically pull it all together and give [Member Regulation] everything that [it was] asking for,” and Member Regulation in fact sent the Firm two additional requests for information. Notwithstanding Member Regulation’s flexibility, the application remained incomplete. Under these circumstances, we reject the Firm’s argument that it should be afforded one last opportunity to remedy the issues unrelated to Owner’s violation of the interim restrictions.

III. Conclusion

After a complete and independent review of the record, we conclude that the Firm has failed to establish that has satisfied all fourteen standards set forth in NASD Rule 1014(a). We affirm Member Regulation's denial of the application.

On behalf of the National Adjudicatory Council,

Marcia E. Asquith,
Senior Vice President and Corporate Secretary