

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

DAVREY FINANCIAL SERVICES, INC.
(CRD No. 38914),

Tacoma, WA,

and

PRAVIN R. DAVREY
(CRD No. 2243197),

Tacoma, WA,

Respondents.

Disciplinary Proceeding
No. C3B020015

Hearing Officer—Andrew H. Perkins

HEARING PANEL DECISION

August 11, 2003

Davrey Financial Services, Inc. violated SEC Rules 17a-3 and 17a-4 and NASD Conduct Rule 2110 and Pravin Davrey violated NASD Conduct Rules 2110 and 3110 by failing to maintain accurate books and records. Davrey also permitted the firm to conduct a securities business when it did not meet its net capital requirement in violation of NASD Conduct Rule 2110 and SEC Rule 15c3-1. For these violations Davrey Financial is censured and fined \$15,000, and Davrey is suspended for two years from associating with any NASD member firm in any capacity and is ordered to requalify as a Financial and Operations Principal before again serving in that capacity. In addition, the Respondents violated NASD Conduct Rule 2110 and NASD Conduct Rules 2210 and 2220 by running a television advertisement (1) containing exaggerated, unwarranted, and misleading statements, and (2) omitting required disclosures and warnings concerning options. The Respondents also failed to submit the options advertisement to NASD for approval. For these advertising violations, Davrey Financial is censured and fined \$20,000, and Davrey is suspended for two years from associating with any NASD member firm in any capacity. Further, the Respondents are

ordered for two years to submit all of their proposed advertising to NASD for pre-use review.

Appearances

For the Department of Enforcement: David Utevsky, Regional Counsel, Seattle, WA; and David Watson, Regional Counsel, San Francisco, CA (Rory C. Flynn, Chief Litigation Counsel, Washington, DC, Of Counsel).

For the Respondents: Pravin R. Davrey.

DECISION

I. INTRODUCTION

The Department of Enforcement (“Department”) brought this disciplinary proceeding against the Respondents Davrey Financial Services, Inc. (“Davrey Financial” or the “Firm”) and Pravin Davrey (“Davrey”), the Firm’s former President, Chief Executive Officer, Chief Financial Officer, and Compliance Officer. In eight causes, the Department charges that the Respondents’ violated: (1) the Securities and Exchange Commission’s books and records requirements, SEC Rules 17a-3 and 17a-4, and the corresponding NASD requirements, NASD Conduct Rule 3110; (2) the rule governing minimum net capital requirements, SEC Rule 15c-3-1; and (3) NASD’s advertising rules, NASD Conduct Rules 2210 and 2220. The advertising violations arose from Davrey’s appearance on a television program that aired on a Los Angeles station in November 1999. In addition, the Complaint alleges that each of the foregoing violations constituted a violation of NASD Conduct Rule 2110, which requires NASD members to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business.

II. PROCEDURAL HISTORY

The Department filed the Complaint on August 9, 2002, and, on September 25, 2002, the Respondents submitted a letter response to the Department in which they admitted to both the net capital and the books and records violations, as alleged in the First and Second Causes of Complaint. However, they asserted that the violations were unintentional. As to the alleged advertising violations, the Respondents admitted that they had failed to submit the program script to NASD for review before the television program aired, but they denied further violations of NASD Conduct Rules 2210 and 2220 and requested a hearing.

Shortly after the Department received the Respondents' Answer, the Department learned that Davrey had filed a voluntary petition in bankruptcy before the Department filed the Complaint. The Department promptly moved for a stay of the proceeding as to Davrey, which the Hearing Officer granted by Order dated September 26, 2002. The Hearing Officer continued the case for hearing against Davrey Financial.

On October 10, 2002, the Hearing Officer held an Initial Pre-Hearing Conference during which the Department moved for an Order requiring Davrey Financial to file an Amended Answer to address more thoroughly the allegations in the Complaint. The Hearing Officer granted the Department's motion.

On November 15, 2002, the Respondents¹ filed their Amended Answer, which set forth with further detail their responses to the specific factual allegations in the Complaint. The Respondents admitted to the same violations as they had in their original Answer.

On January 6, 2003, the Department moved to vacate the stay of the proceeding against Davrey because the Bankruptcy Court had entered an order permitting this case to proceed against Davrey. Accordingly, the Hearing Officer granted the Department's motion.

On January 6, 2003, the Department also filed a Motion for Partial Summary Disposition against the Respondents. Based on the Respondents' admissions of liability in their Amended Answer, the Department moved for entry of an order finding the Respondents liable under the First, Second, and Fourth Causes of Complaint. The Respondents, by counsel,² opposed the Department's motion on the grounds that Davrey had not understood that the Respondents would be prejudiced by their admissions. However, the Respondents did not raise any disputed, material facts. On April 4, 2003, the Hearing Panel granted the Department's Motion for Partial Summary Disposition only as to the first two Causes of Complaint—the books and records and net capital charges. As to the Fourth Cause of Complaint, the Hearing Panel found that the facts alleged in the Complaint were too ambiguous to support the Department's Motion for Partial Summary Disposition. Accordingly, the Hearing Panel denied the Motion as to that Cause of Complaint.

The hearing was held in Seattle, Washington, on May 13, 2003, before a Hearing Panel composed of the Hearing Officer, a current member of the NASD District 3 Committee, and a

¹ The Amended Answer states that it is filed by both Respondents although the proceeding against Davrey was still stayed.

former member of the NASD District 4 Committee. The Department called Dianne DuSault, an NASD Special Investigator; Steven O’Mara, a Supervisor with NASD’s Advertising Regulation Department; and Davrey to testify. The Department also introduced 46 exhibits into evidence (Exhibits C1–7, C9–14, C18–32, C34–46, and C49–52). Davrey testified on behalf of the Respondents and introduced two exhibits into evidence (R1 and R2).³

III. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. The Respondents

Davrey entered the securities industry in April 1992.⁴ He was associated with several firms before founding Davrey Financial in or about April 1995.⁵ At the times relevant to this proceeding, Davrey served as the Firm’s President, Chief Executive Officer, Chief Financial Officer, and Compliance Officer.⁶ He also was the Firm’s Financial and Operations Principal (“FINOP”).⁷ Currently, Davrey is associated with Optionsxpress, Inc., an NASD member firm.⁸

Davrey Financial is a broker-dealer and a member of NASD located in Tacoma, Washington.⁹ The Firm first registered with NASD in December 1995. The Firm is not currently operating due to financial difficulties.¹⁰

² The Respondents’ attorney withdrew from the proceeding effective April 28, 2003.

³ The hearing transcript is cited “Tr.”; the Department’s exhibits as “Ex. C_”; and the Respondents’ exhibits as “Ex. R_.”

⁴ Ex. C1.

⁵ Ex. C2, at 4.

⁶ Davrey stepped down as an officer of the Firm in early 2003.

⁷ Ex. C1, at 6.

⁸ *Id.* at 3.

⁹ Ex. C2.

B. Inaccurate Books and Records

In connection with a routine examination of Davrey Financial in 2000, NASD Staff discovered that the Firm had been making payments out of its operating account to certain shareholders pursuant to the terms of two Stock Redemption Agreements (“Redemption Agreements”), but the corresponding liability was not recorded on the Firm’s books and records.¹¹ NASD Staff then reviewed the Firm’s financial records and calculated the impact of this liability on the Firm’s net capital computations.¹² The resulting calculations show that the Firm incorrectly reported its net capital for the months of April 1999 through August 2000, as shown on Exhibit C6.¹³

NASD Staff then requested that Davrey Financial file an accelerated FOCUS Report for December 2001.¹⁴ That FOCUS Report¹⁵ showed that the Firm had a net capital deficiency of \$10,323 as of the end of December 2001.¹⁶

NASD Conduct Rule 3110 requires members to make and preserve books and records in conformity with all NASD rules and as prescribed by SEC Exchange Act Rules 17a-3 (requirement to make and keep books and records, including ledgers reflecting all assets and

¹⁰ Tr. 221.

¹¹ Tr. 30–31.

¹² *Id.* 32–33.

¹³ *Id.*

¹⁴ *Id.* at 35.

¹⁵ Ex. C13.

¹⁶ Tr. 35.

liabilities) and 17a-4 (requirement to preserve all records required to be made pursuant to SEC Exchange Act Rule 17a-3, paragraphs (1), (2), (3), and (5)).¹⁷

Here, the evidence shows clearly, and Davrey admits, that he failed to record the liability created by the two Redemption Agreements on the Firm's books and records. Davrey's initial argument that the Redemption Agreements created a personal liability rather than a corporate liability is contradicted by the language of the agreements and the Respondents' conduct in making the payments under the agreements from the Firm's operating account. At first, when NASD Staff questioned Davrey about his treatment of the Redemption Agreements, he contended that he should not have to include the liability under the agreements on the Firm's books and records because he had intended the liability to be his personal obligation.¹⁸ Davrey testified that he was to receive the repurchased stock and that he had relied upon his accountants to prepare the Redemption Agreements to reflect that intent because he was too busy to focus on the issue.¹⁹ Davrey did not consider the payments the Firm made to be significant because he viewed the Firm's funds as his own.²⁰ Ultimately, however, Davrey relented and admitted that he erred in failing to include the liability under the Redemption Agreements on the Firm's books and records.²¹ Accordingly, the Hearing Panel concludes that Davrey Financial failed to maintain

¹⁷ See, e.g., *Department of Enforcement v. Block*, No. C05990026, 2001 NASD Discip. LEXIS 35, at *15, n15 (N.A.C. Aug. 16, 2001).

¹⁸ Tr. 30–31, 108.

¹⁹ *Id.* at 108–09, 111–12.

²⁰ *Id.* at 108–09.

²¹ *Id.* at 217; Ex. C11 (letter agreeing to NASD Staff's findings).

accurate books and records, in violation of SEC Exchange Act Rules 17a-3 and 17a-4, and NASD Conduct Rules 2110²² and 3110.

The Hearing Panel further finds that Davrey was responsible for these violations because he was the Firm's President, Chief Executive Officer, Chief Financial Officer, Compliance Officer, and FINOP. As such, he had both the primary and the ultimate responsibility for assuring the accuracy of the Firm's records.²³ Davrey's initial construction of the Redemption Agreements was unreasonable; Davrey lacked a good-faith basis for his position. Accordingly, the Hearing Panel finds that by not recording the liability under the Redemption Agreements on the Firm's books and records Davrey violated SEC Exchange Act Rules 17a-3 and 17a-4, and NASD Conduct Rules 2110 and 3110.

C. Net Capital Violations

It is a violation of SEC Exchange Act Rule 15c3-1 for a broker-dealer to engage in a securities business if it does not meet its net capital requirement. Here, there is no dispute that, when the liability under the Redemption Agreements is added to Davrey Financial's net capital computation, Davrey Financial fell below its required net capital on June 30, 1999, September 30, 1999, December 31, 1999, May 31, 2000, June 30, 2000, July 31, 2000, August 16, 2000, August 31, 2000, and December 31, 2001. Accordingly, the Hearing Panel finds that Davrey Financial

²² NASD Conduct Rule 2110 requires members to observe high standards of commercial honor and just and equitable principles of trade.

²³ See *William H. Gerhauser*, Exchange Act Release No. 40639, 1998 SEC LEXIS 2402 (Nov. 4, 1998) (holding that a controlling executive who is directly involved in accounting and net capital violations incurs responsibility for those violations).

conducted a securities business on those dates in violation of SEC Exchange Act Rule 15c3-1 and NASD Conduct Rule 2110.

In addition, Davrey knew the Firm was in net capital violation on those dates because he was responsible for making the Firm's net capital computations and he made the decision not to include the liability under the Redemption Agreements. Davrey cannot excuse his conduct by claiming that he relied on a consulting firm to provide accurate net capital computations.²⁴ As the Firm's financial principal, Davrey had the responsibility "to understand the net capital rule and to apply its provisions."²⁵ Davrey cannot shift that responsibility to an outside firm. Accordingly, the Hearing Panel also finds that Davrey violated SEC Exchange Act Rule 15c3-1 and NASD Conduct Rule 2110 by allowing the Firm to engage in a securities business when the Firm's net capital was below the required minimum for the periods detailed above.

D. Misleading Advertisement

The remaining six Causes of Complaint concern Davrey's appearance on a paid, television call-in program called "You're on the Line" broadcast by KWHY-TV in Los Angeles on November 9, 1999 (the "Advertisement").²⁶ The Firm paid the broadcaster \$4,000 to air the Advertisement, which was designed to promote the Firm's retail securities business.²⁷ The

²⁴ See *District Bus. Conduct Comm. v. Forbes, Walsh, Kelly & Co.*, No. C10950101, 1997 NASD Discip. LEXIS 42, at *8-9 (N.B.C.C. Aug. 5, 1997).

²⁵ *District Bus. Conduct Comm. v. Pritula*, No. C07960009, 1998 NASD Discip. LEXIS 7, at *7, n.5 (N.B.C.C. Jan. 23, 1998), *aff'd*, Exchange Act Release No. 40647, 1998 SEC LEXIS 2425 (Nov. 9, 1998).

²⁶ Exhibit C31 is a videotape of the television program, which the Hearing Panel viewed at the hearing. Exhibit C34 is a transcript of the Advertisement prepared a court reporter at Davrey's on-the-record interview on May 7, 2002.

²⁷ Ex. C32; Ex. C30; Amended Ans. ¶ 5.

Respondents did not submit the script of the Advertisement to NASD for review before the Advertisement aired.

In general, the Advertisement sought to attract customers who were interested in pursuing an aggressive trading strategy. Davrey explained in the Advertisement that “anybody” could be successful in the stock market if he or she adopted the “mindset” and “psychological traits” that Davrey recommended.²⁸ Davrey touted “aggressive trading or short-term trading,” which he said would produce quicker results.²⁹ Davrey told the audience that to succeed in the stock market they should use a broker—such as himself—who “likes the thrill of that kind of [aggressive] trading.”³⁰

Davrey also advocated options trading as the core element of a successful investment strategy.³¹ Specifically, Davrey urged the audience to adopt the strategies heralded by Wade Cook, a notorious and controversial lecturer who promoted trading options and other high-risk strategies. Indeed, a majority of the Firm’s business in 1999 involved options trading.³²

The Hearing Panel finds that the Advertisement, as a whole, seriously misrepresented the inherent risks of the strategies Davrey recommended. The Hearing Panel further finds that Davrey violated NASD Conduct Rules 2210 and 2220, as alleged in the Complaint. As discussed below,

²⁸ Ex. C34, at 4.

²⁹ *Id.* at 2.

³⁰ *Id.* at 3, 9.

³¹ Ex. C50, at 162–63.

³² *Id.* at 167–68. The Respondents also maintained an Internet site, www.GoOptions.com, to facilitate their customers’ options trading.

Davrey made exaggerated, unwarranted, and misleading statements, and he failed to provide specific warnings and disclosures required in advertisements regarding options.

1. Exaggerated, Unwarranted, and Misleading Statements

Davrey made the following statements in the Advertisement, which were exaggerated, unwarranted, or misleading.

(a) Stocks that will “Really, Really Take Off”

One of the services Davrey advertised he provided, and which he claimed differentiated his firm from other broker-dealers, was a “Stocks to Watch” list. Davrey told viewers that this was a list of stocks that would “rise substantially” within a year or so: In his words, they would “really, really take off.”³³ Although Davrey also believed that the listed stocks had the potential to decline substantially,³⁴ Davrey did not mention that risk in the Advertisement. Thus, the Advertisement violated NASD Conduct Rule 2210(d)³⁵ because it falsely represented the nature

³³ Ex. C34, at 7.

³⁴ Tr. 65.

³⁵ NASD Conduct Rule 2210(d)(1) provides, in relevant part:

A) All member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. No material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communication to be misleading.

(B) Exaggerated, unwarranted or misleading statements or claims are prohibited in all [advertisements]. [A]nd no member shall, directly or indirectly, publish, circulate or distribute any [advertisement] that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

NASD Conduct Rule 2210(d)(2)(B)(i) provides, in relevant part:

In making a recommendation in advertisements ..., a member must have a reasonable basis for the recommendation....

NASD Conduct Rule 2210(d)(2)(C) provides, in relevant part:

of the “Stocks to Watch” list and made an unwarranted promise of those stocks’ future performance.³⁶

(b) The “Master Key” to Stock Selection

In the Advertisement, Davrey asserted that anyone could be successful in the stock market if he or she followed his recommendations and used the tools he provided. One such tool he promised to send callers was the “Davrey Master Key,”³⁷ the use of which he claimed would increase substantially the user’s percentage of success in trading. Davrey further said that the Davrey Master Key had “worked very well” for the Firm.³⁸ The “Davrey Master Key” however contained little more than a list of terms, such as “Volume,” “Contingent Liability,” “Management Change,” “New Marketing,” and “Technicals,” without an explanation of their meaning or application. Thus, the document would be of little use to an investor, contrary to the Advertisement’s representation. In his on-the-record interview, Davrey said that the Master Key was intended as an outline for discussions with DFS customers,³⁹ but he did not mention that qualification in the Advertisement. Accordingly, Davrey not only misled viewers as to the contents of the “Master Key,” but he also made an unwarranted promise that it would

Communications with the public must not contain promises of specific results, exaggerated or unwarranted claims or unwarranted superlatives, opinions for which there is no reasonable basis, or forecasts of future events which are unwarranted, or which are not clearly labeled as forecasts.

³⁶ See, e.g., *Department of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD LEXIS 17, at *23-24 (NAC June 25, 2001).

³⁷ Ex. C43.

³⁸ Ex. C34, at 8.

³⁹ Ex. C49, at 110.

substantially increase their investment success, thereby violating NASD Conduct Rule

2210(d)(1)(B).⁴⁰

(c) Davrey's Book

Davrey claimed that he would send callers a copy of his book that contained "actual techniques" of "some of our most successful clients" who "have taken a small amount of money and made a big amount of money on it."⁴¹ But Davrey's book did not exist at the time, he was not working on the publication of such a book, and he did not have a publisher for such a book.

Davrey's statements therefore were untrue and misleading, in violation of NASD Conduct Rule 2210(d)(1)(B). Not only did Davrey mislead viewers by stating that he had written a book,⁴² but he made the unwarranted promise that the techniques in the nonexistent book would enable them to achieve great investment results.

(d) Davrey's "Million Dollar Plan"

Davrey represented that he had a "million dollar plan" that required a relatively small investment to earn \$1 million in seven years. The plan required a rate of return of nine or ten percent a month. Although Davrey cautioned that he could not guarantee each investor would earn \$1 million, he added, "[H]ey, if we do 2 or \$300,000, is that any harder to take?" To bolster his claim, Davrey told the audience that his plan had been in operation for a year, "and it has

⁴⁰ See *Department of Enforcement v. Aleshire*, No. C8A010060 (O.H.O. June 12, 2002), at http://www.nasdr.com/pdf-text/oho_dec02_07.pdf.

⁴¹ Ex. C34, at 8.

⁴² See *District Bus. Conduct Comm. v. Cruz*, No. C8A930048, 1997 NASD Discip. LEXIS 62 at *88 (N.B.C.C. Oct. 31, 1997) (holding that statement that corporations were paying respondent thousands of dollars to teach their management teams exaggerated his credentials and experience).

worked out very well this year so far.” Davrey drove the point home by adding, “[I]f this keeps up, in another six years we’re going to have a lot of millionaire clients.”⁴³

The Hearing Panel finds that the forgoing constituted unwarranted promises of success, in violation of NASD Conduct Rule 2210(d)(2)(C).⁴⁴ Davrey implied that customers would earn at least \$200,000 to \$300,000 by following his advice. In addition, Davrey failed to disclose that his “million dollar plan” involved complex options strategies and trading on margin,⁴⁵ which would not be suitable for all investors.⁴⁶ Indeed, Davrey did not mention any of the risks involved in those strategies. The Hearing Panel also finds that the statement that the plan has “worked out well” for a year was false and misleading. In fact, Davrey had no evidence that the plan would produce the results he claimed.⁴⁷ Davrey cannot identify any customers who participated in the plan.⁴⁸

(e) Testimonials

To support his argument that viewers should use a broker who specializes in Wade Cook’s trading strategies, Davrey said the Firm would provide them with testimonials from customers who had used those strategies successfully.⁴⁹ These testimonials did not exist.

⁴³ Ex. C34, at 11.

⁴⁴ At another point in the Advertisement, Davrey made a similar misleading claim, stating that he had a “way to play [certain] stocks” that would generate substantial returns from a \$900 investment. (Ex. C-34 at 12.)

⁴⁵ Ex. C49, at 133.

⁴⁶ *Id.* at 137.

⁴⁷ Ex. C37. Davrey admitted in his on-the-record interview that the plan was new, and no results were available.

⁴⁸ Ex. C-49 at 142-43.

⁴⁹ Ex. C34, at 14.

Accordingly, the Hearing Panel finds that this claim is false and misleading, in violation of NASD Conduct Rules 2210(d)(1) and (2).

E. Options Advertising Violations

In addition to the foregoing violations, the Advertisement also violated NASD Conduct Rule 2220, which specifically applies to advertisements pertaining to options. Rule 2220(c)(1) requires members to submit every advertisement pertaining to options to NASD's Advertising/Investment Companies Regulation Department at least ten days prior to use, which Davrey did not do.⁵⁰ In addition, Conduct Rules 2220(d)(1) and (2) require all options advertising to be free of false and misleading information and to contain specific risk disclosures. Such advertising also must warn that options are not suitable for all investors.⁵¹ To the contrary, the Advertisement implied that options were suitable for anybody. For example, Davrey stressed that

⁵⁰ Ex. C49, at 20–24.

⁵¹ NASD Conduct Rule 2220(d)(1) provides, in relevant part:

No member ... or person associated with a member shall utilize any advertisement ... which:

(A) contains any untrue statement or omission of a material fact or is otherwise false or misleading;

(B) contains promises of specific results, exaggerated or unwarranted claims, opinions for which there is no reasonable basis or forecasts of future events which are unwarranted or which are not clearly labeled as forecasts....

NASD Conduct Rule 2220(d)(2)(A) provides, in relevant part:

The special risks attendant to options transactions and the complexities of certain options investment strategies shall be reflected in any advertisement, ... which discusses the uses or advantages of options. Such communications shall include a warning to the effect that options are not suitable for all investors. In the preparation of written communications respecting options, the following guidelines shall be observed:

(i) Any statement referring to the potential opportunities or advantages presented by options shall be balanced by a statement of the corresponding risks. The risk statement shall reflect the same degree of specificity as the statement of opportunities, and broad generalities should be avoided. Thus, a statement such as "with options, an investor has an opportunity to earn profits while limiting his risk of loss," should be balanced by a statement such as "of course,

the Firm's clients came from "every walk of life."⁵² In addition, Davrey failed to advise of the inherent risk in options and failed to warn that an investor "may lose the entire amount committed to options in a relatively short period of time."⁵³ Instead, for example, Davrey emphasized that the use of credit spreads was "an ideal way ... to generate cash flow."⁵⁴ Davrey made no attempt to present a balanced portrayal of the benefits and corresponding risks associated with options.

Davrey also violated NASD Conduct Rule 2220(d)(2)(B)(i) by not including in the Advertisement certain required information about how an investor can obtain an Options Disclosure Document, as required by SEC Exchange Act Rule 134.

Finally, the Advertisement improperly contained projections of performance. For example, in discussing covered calls, Davrey said such an options strategy could provide a return on investment of "10 percent a month."⁵⁵ Davrey dismissed NASD's concern about this statement because he believed it to be possible to achieve that rate of return; thus, the statement was not

an options investor may lose the entire amount committed to options in a relatively short period of time."

(ii) It shall not be suggested that options are suitable for all investors.

NASD Conduct Rule 2220(d)(2)(B)(ii) prohibits "[t]he use of recommendations or of past or projected performance figures, including annualized rates of return...."

⁵² Ex. C34, at 4.

⁵³ See NASD Conduct Rule 2220(d)(2)(A)(i).

⁵⁴ Ex. C34, at 5–6.

⁵⁵ Ex. C34, at 10.

false. However, the applicable Conduct Rule prohibits the use of such projections regardless of their accuracy.⁵⁶

For the foregoing reasons, the Hearing Panel finds that the Respondents violated NASD Conduct Rule 2220, as alleged in Causes Four through Eight of the Complaint.

IV. SANCTIONS

A. Net Capital and Books and Records Violations

The books and records and net capital violations are attributable to a common underlying cause, hence the Hearing Panel will impose a unitary sanction for these violations.⁵⁷

The Hearing Panel's deliberation of the appropriate sanctions under the facts and circumstances of this case begins with the acknowledgment that “[n]et capital violations are serious. The uniform net capital rule is designed to insure that a broker-dealer will have sufficient liquid assets to satisfy its indebtedness, particularly the claims of its customers.”⁵⁸ Nevertheless, the Respondents exhibit a persistent disregard of the rule. NASD cited the Respondents for net capital deficiencies and books and records discrepancies going back to November 1996.⁵⁹ NASD cited them for similar discrepancies in September 1997⁶⁰ and May 1999,⁶¹ and the evidence shows that the violations that are the subject of this proceeding continued over a long period, which the

⁵⁶ See NASD Conduct Rule 2220(d)(2)(B(ii).

⁵⁷ See, e.g., *Department of Enforcement v. Respondent I*, No. C8A990071, 2001 NASD Discip. LEXIS 6, at *30–31 (N.A.C. Apr. 19, 2001).

⁵⁸ *Edward B. Daroza, Jr.*, Exchange Act Release No. 30957, 1992 SEC LEXIS 1709, at *10 (July 27, 1992) (*quoted in Block*, 2001 NASD Discip. LEXIS 35, at *32).

⁵⁹ Ex. C22, at 4 (Letter of Caution).

⁶⁰ Ex. C24.

⁶¹ Ex. C26.

Hearing Panel considers an aggravating factor.⁶² In addition, after NASD Staff brought the net capital violations relating to the Redemption Agreements to the Respondents' attention in August 2000, they committed further net capital violations in November and December 2001.

The Hearing Panel also notes that the Respondents' decision not to record the Firm's liabilities under the Redemption Agreements was based on an unreasonable interpretation of those agreements. The Hearing Panel finds the Respondents' initial defense of their decision not to record the liability particularly troublesome because the May 1999 Letter of Caution also involved their failure to record the Firm's liability under a Stock Redemption Agreement.⁶³ Thus, the Hearing Panel rejects the Respondents argument that their error in failing to record the Redemption Agreements was made in good faith.⁶⁴ Davrey intentionally omitted this liability because he knew that inclusion of the liability would result in a net capital deficiency.

Accordingly, and in consideration of the applicable NASD Sanction Guidelines,⁶⁵ the Hearing Panel concludes that the following sanctions are warranted: Davrey Financial shall be censured and fined \$15,000, and Davrey shall be suspended for two years from associating with any member firm in any capacity and be required to requalify as a FINOP.⁶⁶

⁶² See NASD Sanction Guidelines ("Guidelines") 9 (Principal Considerations Nos. 8 and 9). See also *Gerhauser*, 1998 SEC LEXIS 2402 at *32.

⁶³ Ex. C26.

⁶⁴ In any event, lack of intent does not enter into the determination of whether a financial or operational violation occurred. See *Department of Enforcement v. Respondent 1*, NASD Discip. LEXIS 6, at *33, n.12 (citation omitted).

⁶⁵ Guidelines 33, 34.

⁶⁶ The Hearing Panel has not imposed a similar fine on Davrey because of his bankruptcy proceeding.

B. Advertising Violations

The Hearing Panel also will address the advertising violations in the Fourth through Eighth Causes of Complaint with a unitary sanction because they also have a common underlying cause.

In assessing the appropriate sanctions for these violations, the Hearing Panel began with the applicable Guideline. For failure to file advertising materials with the NASD Advertising Department, the Guidelines recommend a fine of \$1,000 to \$15,000 and a suspension for up to five business days. The pertinent principal considerations for this violation are (1) whether the failure to file was inadvertent and (2) whether the advertisement was circulated widely.⁶⁷ For the intentional or reckless use of misleading advertising, the Guidelines recommend a fine of \$10,000 to \$100,000 and consideration of a suspension for up to two years.⁶⁸ In addition, for egregious cases, the Guidelines recommend imposition of a “pre-use” filing requirement to obtain a “no objection” letter for all proposed advertisements and other communications with the public.⁶⁹

Applying these considerations to the present case, the Hearing Panel finds that the Respondent’s violations were, at a minimum reckless, and the Advertisement circulated widely. In addition, the Hearing Panel notes that in 1996 NASD issued a Letter of Caution to the Firm citing similar violations of Rules 2210 and 2220, which is an aggravating factor.⁷⁰ Other aggravating factors the Panel considered included Davrey’s lack of credibility,⁷¹ the seriousness of his

⁶⁷ Guidelines 87.

⁶⁸ *Id.* at 89.

⁶⁹ Guidelines 87.

⁷⁰ See *Sheen Fin. Resources, Inc.*, Exchange Act Release No. 35477, 1995 SEC LEXIS 613, at *19 (Mar. 13, 1995).

⁷¹ *Thomas S. Foti*, Exchange Act Release No. 31646, 1992 SEC LEXIS 3329, at *5-6, *13 (Dec. 23, 1992).

misleading statements and omissions,⁷² and Davrey’s “continued refusal to appreciate” that his communications were misleading.⁷³ On this issue of Davrey’s credibility, the Hearing Panel found significant the fact that Davrey could not explain why he considered the Advertisement to be exempt from the filing requirements of NASD Conduct Rules 2210 and 2220. Another relevant factor is that Davrey attempted to conceal his misconduct by informing NASD Staff that the Firm had not engaged in any advertising during the period when it ran the Advertisement.

As a whole, therefore, the Hearing Panel finds that more serious sanctions should be imposed than those the Department requests. Although the Department presented no evidence of actual customer harm, the potential for harm was grave. Davrey’s characterization of high-risk, exotic options strategies as relatively safe strategies for the average investor was a gross violation of the rules governing options advertising. Accordingly, the Hearing Panel concludes that the following sanctions are warranted for the multiple advertising violations: Davrey Financial shall be censured and fined \$20,000, and Davrey shall be suspended for two years from associating with any member firm in any capacity. In addition, for a period of two years, the Respondents shall submit all of their proposed advertising to the NASD Department of Advertising for “pre-use” approval. The “pre-use” filing requirement shall commence for Davrey Financial once this Decision becomes the final disciplinary action of NASD, and the period shall commence for Davrey when he re-enters the securities industry following the suspension imposed in this Decision.

⁷² *Department of Enforcement v. Pacific On-Line Trading & Secs, Inc.*, No. C01000037, 2002 NASD Discip. LEXIS 19, at *34 (N.A.C. Nov. 27, 2002).

V. ORDER

Therefore, having considered all the evidence,⁷⁴ the Hearing Panel orders as follows:

A. Net Capital and Books and Records Violations—First and Second Causes of Complaint

- 1) Davrey Financial is censured and fined \$15,000.
- 2) Davrey is suspended for two years from associating with any member firm in any capacity and ordered to requalify by examination as a FINOP before again serving in such capacity.

B. Advertising Violations—Third through Eighth Causes of Complaint

- 3) Davrey Financial is censured and fined \$20,000. Davrey Financial shall submit all of its proposed advertising to the NASD Department of Advertising for “pre-use” approval for a period of two years beginning when this Decision becomes the final disciplinary action of NASD.
- 4) Davrey is suspended for two years from associating with any member firm in any capacity. In addition, Davrey shall submit all of his proposed advertising to the NASD Department of Advertising for “pre-use” approval for a period of two years beginning when Davrey re-enters the securities industry following his suspension.

⁷³ *Id.*

⁷⁴ The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.

The Respondents also are jointly and severally ordered to pay the costs of this proceeding in the total amount of \$1,933.42, which include an administrative fee of \$750 and hearing transcript costs of \$1,183.42.

Except as otherwise stated, these sanctions shall become effective on a date set by the NASD, but not sooner than 30 days from the date this Decision becomes the final disciplinary action of the NASD. If this Decision becomes the final disciplinary action of NASD, Davrey's suspension shall become effective with the opening of business on Monday, October 6, 2003, and end at the close of business on October 5, 2005.

Andrew H. Perkins
Hearing Officer
For the Hearing Panel

Copies to:

Davrey Financial Services, Inc. (by overnight courier and first-class mail)
Pravin R. Davrey (by facsimile and first-class mail)
David Utevsky, Esq. (by first-class and electronic mail)
Rory C. Flynn, Esq. (by first-class and electronic mail)