NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C9B010041
v.	:	
	:	Hearing Officer - AWH
JAMES B. MORAN Basking Ridge, NJ (CRD #1180416),	:	
	:	**Hearing Panel Decision**
Respondent.	:	July 9, 2002

Registered representative found (1) not liable for engaging in private securities transactions, in violation of Conduct Rules 3040 and 2110, but (2) liable for engaging in outside business activity without providing member firm with prompt written notice, in violation of Conduct Rules 3030 and 2110. Respondent fined $5,000, and suspended from associating with any member firm in any capacity for 10 business days.

Appearances:

Thomas M. Huber, Esq., for the Department of Enforcement

Richard C. Szuch, Esq., and Stephen M. Plotnick, Esq., for James B. Moran

DECISION

On May 15, 2001, the Department of Enforcement ("Enforcement") filed the two-cause Complaint in this matter, alleging, in the alternative, that James B. Moran ("Moran" or "Respondent") either (1) engaged in private securities transactions without giving prior written notice to his employing member firm; or, (2) engaged in outside business activity without giving prompt written notice to the member firm of his "employment with and/or acceptance of compensation from" one of two limited liability companies. Both causes pertain to Siena Baja, L.L.C., and Baja Wyckoff, L.L.C., a franchisee and a sub-franchisee, respectively, of quick-

service Mexican food restaurants. On June 25, 2001, Respondent filed an Answer to the Complaint, denying the allegations against him, asserting a number of affirmative defenses, and setting forth a counter-statement of facts. A hearing was held in Woodbridge, New Jersey, on February 5 and 6, 2002, before a hearing panel composed of the Hearing Officer and two current members of District No. 9. Both parties filed post-hearing briefs.

Findings of Fact[1]

I. BACKGROUND OF MORAN AND THE BAJA TORTILLA GRILL CONCEPT

James B. Moran first entered the securities business in 1983. He was associated with Merrill Lynch, Pierce, Fenner & Smith, Inc., ("Merrill Lynch") from the beginning of 1987 to mid-December 1999, with the exception of a 15 month period beginning in September 1994 and ending in December 1995, when he was associated with Kidder, Peabody & Company, Inc. and PaineWebber, Inc. He was last registered through Merrill Lynch as a General Securities Representative from January 2, 1996, to December 13, 1999. He is currently registered with NASD through Financial Consultant Group, L.L.C. CX 1. Prior to the issuance of the Complaint in this proceeding, his history in the securities industry was unblemished.

Moran had been college friends with Peter Miller and Thomas Jones. Sometime in or about early November 1995, Miller, who had been involved with fast-food restaurants in the Washington, D.C., area, called Moran seeking Jones' telephone number. Miller explained that he had been exposed to a new Mexican fast-food restaurant concept about which he wanted to talk to Jones. Jones was a certified public accountant who had had previous experience owning, operating, and selling several Burger King, Boston Chicken, and Chesapeake Bagel franchises. Tr. 28-29, 286.

[1] References to Enforcement's exhibits are designated as CX_; Respondent's exhibits, as RX_; and the transcript of the hearing, as Tr._.

Miller was acting on behalf of Jim Maruna, president of Tortilla Ventures, Inc. ("Tortilla Ventures"), a company that was developing a chain of Mexican fast-food restaurants named Baja Tortilla Grill. Because of Jones' experience with fast-food franchises, Miller, Maruna, and Tortilla Ventures wanted Jones to become an area developer for their restaurants in New York. Tr. 28-32. Moran told Jones that he was interested in becoming involved in the restaurants if Jones decided to pursue the opportunity Miller was presenting. Tr. 32-33.

Tortilla Ventures ultimately decided that it did not want Jones to open restaurants in the New York area; however, it made the New Jersey area available to him. Tr. 34-35. Jones, who lived in Long Island, decided to pursue the opportunity in New Jersey. Moran lived in New Jersey, and he and Jones discussed how Moran might become involved in the business venture and what role he might have in it. *Id.* The nature and scope of Moran's role was not clearly defined or determined in early November 1995, but he acted as a liaison in New Jersey for Jones, transmitting information to potential investors, seeking information on potential restaurant locations, and trying to function in ways that would earn him sweat equity in the venture. Tr. 35, 42, 46-47, 54, 62-63.

Sienna Baja, L.L.C., ("Sienna Baja") was formed as the legal entity that would be the area developer for Baja Tortilla Grill restaurants in New Jersey.[2] Sienna Baja and Tortilla Ventures executed an area development agreement granting Sienna Baja the exclusive right to develop, construct, manage, and operate Baja Tortilla Grill restaurants in New Jersey. CX 8; Tr. 287. Jones decided that separate limited liability companies would be formed to own individual Baja Tortilla Grill restaurants, and that Sienna Baja would own a majority interest in each. Baja

[2] Sienna Baja was formed on February 1, 1996, pursuant to the provisions of the New Jersey Limited Liability Company Act, N. J. S. A. 42:2B-1, *et seq.* CX 7. The name Sienna Baja was chosen and used in correspondence and on business cards as early as November 1995. CX 4; Tr. 38, 44-45.

Wyckoff, L.L.C., ("Baja Wyckoff") was to be the first such limited liability company to own and operate an individual Baja Tortilla Grill restaurant in New Jersey. Tr. 287-88.

Jones chose the limited liability company form based on his experience with Chesapeake Bagel franchises. That structure allowed for profits from the restaurants to be distributed in proportions different from ownership interests. For example, individuals who contributed more sweat equity to the business on a day-to-day basis could receive a larger percentage of profits from the restaurant. Tr. 290-92.

Jones contemplated an owner/operator business model for the concept, as opposed to a "strict investor" model in which the investors are similar to silent partners. Tr. 290-91. Under the owner/operator model, Sienna Baja and several other investors would finance each restaurant. Each of the investors would have the ability to participate and play an active role in the business. Tr. 288-91, 296-98. Consistent with that model, Jones solicited feedback and ideas from potential investors before they had actually invested and while the restaurant concept was in its initial stages. CX 5; Tr. 62. Jones projected that it would take $200,000 to $300,000 to open a restaurant. Because he wanted to encourage and allow for active investor participation in the restaurant, he limited the number of investors and sought a minimum investment of $25,000 from each. Tr. 95-98, 288-91.

II. FINANCING FOR THE BAJA TORTILLA GRILL VENTURE

Jones learned of a group of attorneys from Washington, D.C., who had been involved with Miller in Baja Tortilla Grill restaurants in Virginia. Those attorneys were interested in expanding their investments into the New Jersey area, through both Sienna Baja, the master franchiser for New Jersey, and Baja Wyckoff, the initial restaurant. Jones told Moran that he had

other investors lined up, including a client who did business in Hong Kong. Moran had no contact with the Washington attorneys or Jones' client. Tr. 35-37, 63-64, 138-40.

A. Investor A.L.

In November 1995, Jones asked Moran to prepare and send an informational letter to several individuals who had expressed an interest in investing in the first restaurant. One of those individuals was A.L., who was a tax client of Jones, and who knew that Jones had been involved in several fast-food franchises. In late March or early April 1995, when Jones was meeting with her to go over her tax returns, A.L. expressed an interest in a franchise investment. She told Jones to let her know if he came across a similar investment in the future because she was interested in earning more than she could in the stock market.[3] When he became involved in the Baja Tortilla Grill venture, Jones called A.L. about it, and he asked Moran to forward the informational letter to her. CX 4; Tr. 42-43, 94, 292-94.

A.L. and Moran had known each other since Moran was a child. A.L. had worked with Moran's father at a union of broadcast engineers and technicians for over thirty years. She was still working for the union in late 1995. Tr. 44, 67. She and Moran had a close personal relationship; they conversed frequently; they shared family dinners; and, from 1993, she maintained a securities account with him.[4] CX 29; Tr. 44, 91. A.L. had no business or employment experience involving restaurants or food service. Tr. 67-68.

[3] CX 29 is A.L.'s signed Declaration, dated October 7, 1999, that states as follows: "I did not discuss investing in Siena Baja, Inc. with anyone other than Moran. I did not consult with or even mention this investment to my accountant, Mr. Tom Jones, prior to investing." A.L. did not testify at the hearing. Jones testified by telephone at the hearing. Asked to comment on the above statement of A.L., Jones replied "That's an absolute falsehood." Jones' testimony was certain as to the time of his conversation with A.L. because it occurred during income tax season. Without the opportunity to assess the credibility of A.L. as a witness, the Hearing Panel cannot determine whether Jones' testimony might refresh her recollection of a conversation with him, whether she might wish to change her testimony, or whether she would affirm the statements in her Declaration. The burden of proof on any issue is on Enforcement. The Hearing Panel finds Jones to be a credible witness, and, under the circumstances, it cannot credit A.L.'s Declaration where it conflicts with Jones' testimony.

[4] The account was opened at Merrill Lynch, was transferred to PaineWebber, Inc., when Moran associated with that firm, and was then transferred back to Merrill Lynch when Moran rejoined Merrill Lynch.

After she spoke with Jones about Baja Tortilla Grill, A.L. spoke with Moran about investing in a restaurant. Tr. 69. Moran told her what he learned as an investor in a Chesapeake Bagel franchise. She was interested in the concept and expressed ideas about it. Moran expected her to be more than a passive investor. Tr. 69. A.L. was familiar with the northern New Jersey area and suggested possible locations for the restaurant. Tr. 53. Eventually, and as discussed in more detail below, she invested $25,000 in the Baja Tortilla Grill restaurant that Siena Baja was developing. CX 9-10; Tr. 83, 92-95, 97, 111.

B. Investor D.M.

D.M. and Moran were personal friends, having known each other since Moran was about 16 years old. D.M. was employed in the field of public education. In late 1995, he was the superintendent of schools for a public school system in New York. D.M. also maintained a securities account for which Moran was the broker. Tr. 99, 101, 108. At a luncheon meeting, Moran told D.M. about Jones and his prior experience and success with fast-food franchises. D.M. indicated to Moran that he would be interested in investing funds from an inheritance that he was about to receive. Even though D.M. wanted to invest only $10,000, Moran agreed to approach Jones about such a small investment. Although D.M. had no business experience involving restaurants, Moran believed he could provide valuable input to the venture because D.M. knew the area proposed for the first restaurant, would be a source of information on locations and real estate agents, and would know teenagers who might be interested in working in the restaurant. Tr. 102-11.[5]

[5] D.M. did not testify at the hearing. He did provide the staff with a signed Declaration, dated January 2000. CX 30. The Declaration, however, did not address all points raised by Moran's testimony at the hearing.

C. Investors T.L. and J.L.

T.L. is Moran's father-in-law and a retired New Jersey state policeman. He had also owned pizza establishments in Paterson, New Jersey. After learning about the Baja Tortilla Grill venture, T.L. became interested in investing in it. T.L.'s son had experience in the restaurant business, having managed a Friendly's restaurant. T.L. suggested that his son should serve as the manager of the first Sienna Baja restaurant. T.L.'s brother, J.L., owned a restaurant in Paterson, New Jersey. Tr. 111-13.

Moran informed T.L. that Jones was looking for a $25,000 minimum investment, but that Jones had allowed D.M. to invest only $10,000. Moran told T.L. that, because of his relationship with Moran, his and his brother's experience in the restaurant business, and his son's experience and desire to serve as the day-to-day operator of the restaurant, Jones might allow T.L. to invest less than $25,000. Jones agreed to a smaller investment, and T.L. and J.L. together invested $10,000 in the first restaurant. Tr. 113-15. T.L. and J.L. suggested suppliers for restaurant fixtures and equipment, as well as suggesting locations for the restaurant. T.L.'s son helped to select a real estate agent. Tr. 116-17.

III. CHRONOLOGY OF EVENTS AND DISCLOSURE OF THEM TO MERRILL LYNCH

On or about November 10, 1995, Moran sent A.L. and others a form letter on which a Baja Tortilla Grill logo appeared at the top. The letter concerned the progress of Siena Baja, Inc., as the master franchisee in New Jersey. It explained that Sienna Baja, Inc., planned eventually to build 10 restaurants, and that the parent company, Baja Tortilla Grill, Inc., planned "to take the company public within the next two years, and in the process, buy back a number of the operating restaurants." CX 4. On or about December 8, 1995, Moran sent A.L. and others a second letter bearing a Baja Tortilla Grill logo. The letter provided information about the

activities of "Siena Baja LLC," stating that "[w]e are in the process of locating an attractive site for our first store…Please call me directly to discuss any locations that you may be aware of, which you think would be attractive. We are looking for roughly 1,500 sq ft., high visibility, end cap etc. etc." CX 5.

On December 15, 1995, Moran left PaineWebber, Inc., and rejoined Merrill Lynch in Wayne, New Jersey. Charles Ganjamie was the manager of that Merrill Lynch office at that time. Tr. 25, 27, 59. On December 21, 1995, Moran competed a Merrill Lynch Outside Interest Questionnaire ("OIQ"). CX 6. On the OIQ, Moran reported that he had no outside employment or business interests. At that time, he had no formal role with Sienna Baja, and he was unsure of his precise relationship with that entity. Tr. 71-72. On January 4, 1996, Frank Heter signed the OIQ as Supervisory Officer. CX 6.

On February 1, 1996, the Certificate of Formation was filed for Siena Baja, L.L.C., with the New Jersey Secretary of State. It listed Moran's home address as the initial registered office of Siena Baja and identified Moran as the registered agent at that address. CX 32. On February 14, 1996, Tortilla Ventures and "Siena Baja Corp." entered into their Area Development Agreement noted above. CX 8. Moran signed the Agreement on behalf of Siena Baja.

On February 15, 1996, $25,000 was wired from A.L.'s securities account at Merrill Lynch to the Siena Baja L.L.C. bank account that Moran and Jones had opened together in Totowa, New Jersey. Moran's home address was used as the address for the account, and he had authority to write checks on the account. Tr. 79-80, 82. Moran was responsible for paying vendors with whom Siena Baja dealt. Tr. 85.

Also on February 15, 1996, Moran completed a second OIQ and submitted it to Merrill Lynch. This OIQ was the annual form that Merrill Lynch required of all employees. Tr. 118-19.

On that form he disclosed an interest as an "investor/partner" in "Chesapeake Bagel Bakery." He did not disclose any interest in Siena Baja or Baja Tortilla Grill on the OIQ. He was aware that Merrill Lynch policy required that he obtain approval from his manager and from Merrill Lynch's compliance department before engaging in any proposed outside business activity. However, at the time he completed the OIQ, he was still not sure of his exact role in Siena Baja or whether, from a legal perspective, it was "really up and running yet." CX 12; Tr. 118-21. On February 27, 1996, Frank Heter signed the OIQ as Supervisory Officer. *Id.*

On February 22, 1996, D.M. wired $10,000 from a personal bank account to the Siena Baja L.L.C. bank account, in order to invest in the first restaurant. CX 30, 31; Tr. 109. The investment by T.L. and J.L. was made at some time unspecified in the record.

Moran did not attempt to conceal his relationship with Siena Baja. Most of his co-workers in the Merrill Lynch office came to know of Moran's involvement with the Baja Tortilla Grill concept. Tr. 121-23. At an unspecified time, Jones visited the Merrill Lynch office and was introduced to those co-workers, including one of Moran's supervisors, as one of the individuals with whom Moran was involved in connection with Baja Tortilla Grill. Tr. 298-300.

By memorandum dated June 5, 1996, Thomas P. McDonnell, III, an employee in the Compliance Department at Merrill Lynch, approved Moran's outside activities noted in the OIQ Moran signed on February 15, 1996. Those outside activities referred to Chesapeake Bagel, and were approved "based on the information provided." CX 13.

As more fully described below, the investors in Baja Wyckoff executed a limited liability company operating agreement that was dated September 4, 1996. Moran signed the operating agreement on behalf of Siena Baja, and Jones signed on his own behalf. A.L., D.M., T.L., and J.L. also signed the operating agreement, as did an individual on behalf of JTR Enterprises,

L.L.C., and another individual on his own behalf. Also on September 4, 1996, consistent with Moran's efforts to acquire a sweat equity interest in the venture, and because he believed that the receipt of the full amount of financing from the Washington attorneys was imminent, he signed a lease agreement on a restaurant site in Wyckoff, New Jersey. Moran signed the lease on behalf of Baja Wyckoff, L.L.C. CX 14. For the same reasons, he also personally guaranteed that lease. CX 15. When the venture ultimately failed, Moran paid the landlord $25,000 from his personal funds pursuant to the guarantee. Stipulation.

At sometime prior to the time that the Baja Wyckoff lease was signed, Jones hired James Thompson ("Thompson") to serve as a "store manager." Thompson had prior experience in the restaurant business. He was paid $6,000 per month from the Siena Baja bank account, and his general responsibilities included looking for a location for the restaurant, working with architects and engineers on the design and build-out of the restaurant, and locating equipment. Moran's role continued as liaison for Jones, obtaining information from Tortilla Ventures, Thompson, and service providers, and writing checks on Siena Baja's bank account to pay expenses incurred to open the first restaurant. Tr. 124, 159-62, 167, 302-03.

On September 25, 1996, Moran voluntarily updated his OIQ and submitted it to Merrill Lynch. CX 18; Tr. 150. On it, he reported having a business interest in "Siena Baja LLC," and described the nature of the business as "'Tortilla Grill' franchise (Mexican food concept) restaurant." He listed his position as "member of LLC" with "no specific duties." He reported that his percentage ownership or financial interest in the entity was 39 percent. That figure was an estimate of the worth of the sweat equity he contributed to the business. Tr. 151-52. Because he did not differentiate between Siena Baja and Baja Wyckoff for purposes of completing the OIQ, he did not mention Baja Wyckoff on the form. Tr. 173-74. At the time he submitted the

OIQ, Moran discussed his entire involvement in the Baja Tortilla Grill venture with Frank Heter, the administrative manager of the Merrill Lynch branch office. Tr. 153. Heter also signed Moran's OIQ as the Supervisory Officer. CX 18.

In February 1997, Thompson was dismissed by Jones for, among other reasons, unsatisfactory performance and a personality conflict between the two men. Moran took over Thompson's role and received approximately $2,000 per month for his services. Moran wrote paychecks to himself, with Jones' prior approval. Tr. 162-72.

On February 26, 1997, Moran completed another annual OIQ and submitted it to Merrill Lynch. CX 25; Tr. 172-73. He reported having a business interest in "Siena Baja," describing it as "Tortilla Grill, Mexican Restaurant." He noted his position as "Investor/Partner," reported that he had "No Specific Duties," and claimed a 25% interest in the business which was worth $25,000. Although he had not put any money into the venture, his claim of a 25% interest worth $25,000 was based on an estimated value of the sweat equity he thought he had invested in the business. Tr. 178-79. There was no line item on the form for compensation, and Moran did not disclose his compensation anywhere on that form. CX 25. At the same time he submitted this OIQ, he also sent a memorandum to the Merrill Lynch branch manager, noting that he had disclosed his involvement with Tortilla Grill the previous fall, but had not received notice of approval of the updated OIQ [signed on September 25, 1996] as he had after he filed his last annual OIQ in February 1996. CX 24; Tr. 180. On July 18, 1997, McDonnell sent Moran a copy of a memorandum by which he approved Moran's outside business activities, based on the information Moran provided on the February 26, 1997, OIQ. CX 26; Tr. 183.

IV. THE BAJA WYCKOFF OPERATING AGREEMENT

Section 5.1 of the Baja Wyckoff Operating Agreement provided for the appointment of a managing member who would be responsible for the operation of the business. The managing member was vested with the authority to do all things in furtherance of Baja Wyckoff's business. However, the managing member could not act without the consent of all members of Baja Wyckoff. No managing member was ever actually appointed. CX 16; Tr. 296-97.

Section 5.2 of the Baja Wyckoff Operating Agreement provided that any member could, at any time, call a meeting of the members. The presence of 80% of the members was required to constitute a quorum. CX 16. A vote of 80% or more of the members was required to constitute "approval" by the members where the Operating Agreement required such approval *Id*.

Section 5.4.1 of the Baja Wyckoff Operating Agreement required each member of Baja Wyckoff to "devote such time to the business and affairs of the Company as is necessary to carry out the [m]ember's duties" as set forth in the agreement. Section 6.1 provided that no member may transfer any interest or rights in any interest, except to an immediate family member. *Id*.

Section 6.2 of the Baja Wyckoff Operating Agreement provided that any member may voluntarily withdraw from the Company. However, Section 7.1.3. provided that the Company must be dissolved upon the occurrence of a voluntary withdrawal, unless the remaining members unanimously elect to continue the business pursuant to the terms of the Operating Agreement.

V. FAILURE OF THE BAJA WYCKOFF VENTURE

In late 1997 or early 1998, the business venture conducted under the name of Baja Wyckoff failed before the restaurant opened because of a lack of funding from both the Washington attorneys and Jones' Hong Kong business contact. Tr. 294, 303. Peter Miller

contacted Moran, telling him that he would prevent the attorneys from investing in the venture unless Miller received a finder's fee for the referral. Jones refused to agree to the fee, and, as a result, the attorneys did not invest in Siena Baja. Tr. 139-40. The Hong Kong business contact became embroiled in a lawsuit that prevented him from investing in the venture. Tr. 303-04.

Discussion

I. THE EVIDENCE FAILS TO DEMONSTRATE A VIOLATION OF CONDUCT RULES 3040 AND 2110

The parties agree, and the Hearing Panel finds, that A.L., D.M., T.L., and J.L. (collectively "the Investors") invested in Baja Wyckoff, and that they intended to be part owners of the first Baja Tortilla Grill restaurant to be opened in New Jersey. As noted by Enforcement, because the location of the first restaurant was not determined until September 1996, the name of the entity through which the first restaurant would be operated was not known when the Investors tendered their funds.

Conduct Rule 3040 prohibits a person associated with a member from participating in any manner in a private securities transaction without prior written notice to, and the written approval of, the member with which the person is associated. For there to be a violation of Conduct Rule 3040, the transaction at issue must involve a "security." Here, the applicable test for determining whether the limited liability interest that the Investors acquired was an "investment contract," and therefore a "security," is set forth in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946).

In *Howey*, the Supreme Court defined an "investment contract" as any transaction in which "[1] a person invests money [2] in a common enterprise and [3] is led to expect profits solely from the efforts of others." *Id.* at 301. Although the limited liability company form of organization is a relatively new creation and was not in existence at the time *Howey* was decided,

courts have consistently applied the *Howey* test. *See, e.g., Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376, 389 (D.Del. 2000); *Keith v. Black Diamond Advisors, Inc.*, 48 F. Supp 2d 326, 332 (S.D.N.Y. 1999). Because the parties in this case agree that the Investors invested money in a common enterprise, expecting to earn profits, the only contested issue in determining whether the Investors entered into an "investment contract" is whether the profits they expected were to be derived "solely from the efforts of others." Enforcement's Post Hearing Brief, at 16-17; Respondent's Proposed Conclusions of Law, at 18.[6]

Membership interests in LLCs are distinct from those in general partnerships and limited partnerships. Members of LLCs are entitled to limited liability, and, depending on the terms of the operating agreement used to form the entity, members may be less involved in the management of it than partners in a general partnership. The critical point is that a member of an LLC may be an active participant in management and still retain limited liability. *See Monsanto*, 96 F. Supp. 2d at 391-92. In limited partnerships, limited partners are protected by limited liability, but become liable as general partners if they exercise a managerial role. *Id*.

The structure of LLCs allows for three management alternatives: member management, manager management, and hybrid management. *See Black Diamond Advisors*, 48 F. Supp. 2d at 332-33; see also Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated As Securities and Possible Steps to Encourage This Result*, 45 Hastings L.J. 1223, 1227-78 (1994). In member managed LLCs, members have ultimate power over the LLC. In manager managed LLCs, a manager member is "vested with the sole power to bind the

[6] The word "solely" should not be construed literally, but should be interpreted broadly. *S.E.C. v. Glenn W. Turner Enterpises, Inc.*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973). In that case, the Ninth Circuit held that the third element in the *Howey* test required proof that the efforts of others "are the undeniably significant ones, those essential managerial efforts that affect the failure or success of the enterprise." That approach has been followed by numerous other federal circuits. *See, e.g. S.E.C. v. Professional Assocs.* 731 F.2d 349, 357 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984).

company and take all other acts necessary to carry on its business and affairs . . . non-managing members are merely passive investors whose interests are not unlike those of limited partners in a limited liability partnership." *Black Diamond Advisors*, 48 F. Supp. 2d at 332-33. In the hybrid model, members delegate actual authority to managers, but retain apparent authority. Under this model, members are treated like general partners who are considered to be relying on the entrepreneurial efforts of others only when the general partner was "so dependent on the promoter or a third party that he was in fact unable to exercise meaningful partnership powers." *Id*. at 333-34 (citing *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981)). "[T]he determination whether a partnership interest is a security 'does not and should not hinge on the particular degree of responsibility [a partner] assumes within the firm,' nor does the delegation of membership responsibilities, or the failure to exercise membership powers 'diminish the investor's legal right to a voice in partnership [or company] matters.'" *Hirsch v. DuPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), (quoting *New York Stock Exchange Inc. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1967)).

In *Monsanto*, the court considered the structure of the LLC, as provided in its operating agreement, to determine whether a member's profits were to come solely from the efforts of others. The court found that the members of NSC (the limited liability company) had no authority directly to manage the business and affairs of the company. Nevertheless, the court found that the investors were not passive because the operating agreement conferred upon them the authority to remove any manager, with or without cause, and to dissolve the company. *Monsanto*, 96 F. Supp. 2d at 392. The court concluded that the operating agreement gave members the power "to directly affect the profits" they received from NSC, and therefore, those profits did not come solely from the efforts of others. *Id*.

Here, the Baja Wyckoff Operating Agreement vests greater powers in the members of the LLC than those vested in the members in *Monsanto*. Section 5.1 of the Baja Wyckoff Operating Agreement purported to appoint a manager of Baja Wyckoff who was to be responsible for the operation of the business and was vested with the authority to do all things determined to be in furtherance of the company. However, because the concept was never fully developed, no manager was appointed.[7] Regardless of any appointment of a manager member, Section 5.1 prohibited the managing member from exercising his authorities or otherwise binding the company to any agreement without the consent of *all* members of Baja Wyckoff. Moreover, although any member could call a meeting, Section 5.2 of the Baja Wyckoff Operating Agreement set a quorum requirement of 80 percent.[8] Therefore, this section required participation by members in order to meet, vote on matters, or ratify actions of the managing member. Section 5.2 is consistent with Section 5.4.1 of the Operating Agreement which requires each member to "devote such time to the business and affairs of the Company as is necessary" to carry out the members' duties as set forth in the agreement. The Operating Agreement also provides for dissolution of the company upon the voluntary withdrawal of a member and the subsequent failure of the other members unanimously to vote to continue the business. Finally, because the Operating Agreement also provides for protection from calls for additional capital (Section 3.2) and the right to participate in a detailed cash flow distribution structure (Section IV), the level of member control is similar to that which the court in *Black Diamond Advisors*

[7] Although Thompson functioned as "store manager," and Moran took over that role when Thompson was fired, Thompson's tenure began prior to the execution of the Baja Wyckoff Operating Agreement, and neither Thompson nor Moran was appointed "managing member" under the Operating Agreement. There is no evidence that either Moran or Thompson became a member of the LLC at any time, although Moran signed the Operating Agreement on behalf of Siena Baja.

[8] Although the Baja Wyckoff Operating Agreement (CX 16) purports to append an exhibit showing the percentage ownership of each member, no such exhibit was attached to the copy of the Operating Agreement entered into evidence at the hearing.

found to be "antithetical to the notion of member passivity required under the fourth prong[9] of Howey." *Black Diamond Advisors*, 48 F. Supp. 2d at 333.

None of the Investors testified at the hearing, and Declarations were submitted for only two of them. However, those Declarations do not address the issue of their expectations, in terms of active participation in their investments. Although Jones was the primary decision maker for Siena Baja and the Tortilla Grill restaurant concept prior to the formation of Baja Wyckoff, his role was the necessary predicate to the evolution of the whole venture. Baja Wyckoff, itself, was always inchoate, never perfected in its final form because it failed before it could come to full fruition. Accordingly, there is scant evidence of how the Investors actually participated, and none that could predict what their involvement would have been, had the restaurant succeeded. However, that evidence is not relevant to a determination whether the interests of the Investors were "securities," because they had the power under the Baja Wyckoff Operating Agreement directly to affect the profits that they were to receive from Baja Wyckoff. Moreover, the mere choice of an investor to remain passive is not sufficient to make the arrangement an investment contract when he or she has the power to exercise control over the business, unless the evidence demonstrates that the investor was so dependent on the promoter or third party that he or she was in fact unable to exercise meaningful power. *See Black Diamond Advisors*, 48 F. Supp. 2d at 333. Here, the Hearing Panel concludes that the Investors had the power to exercise control over their investments, and that there is no evidence upon which it could conclude that they were so dependent on Jones, or anyone else, that they were in fact unable to exercise control over their investments in Baja Wyckoff. Finally, the Hearing Panel notes that investors in franchise businesses are afforded regulatory protections by the Federal

[9] The court divided the third prong of the *Howey* test into two parts, to wit, (3) the expectation of profits (4) solely from the efforts of others.

Trade Commission. 16 CFR Part 436, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures. Accordingly, the Hearing Panel concludes that the investments at issue are not "securities," and the evidence does not demonstrate that Moran violated Conduct Rules 3040 and 2110 as alleged in Cause One of the Complaint.

II. MORAN VIOLATED CONDUCT RULES 3030 AND 2110

The evidence demonstrates that Moran engaged in outside business activity through Siena Baja and Baja Wyckoff without giving Merrill Lynch prompt written notice of that activity or his receipt of compensation for that activity. On brief, Moran admits that the notice he did give to Merrill Lynch was "inadequate for purposes of satisfying the requirements of NASD Conduct Rule 3030." Respondent's Brief, at 26.

Moran began his efforts at earning sweat equity in the Tortilla Grill Restaurant venture in November 1995, approximately one month before he rejoined Merrill Lynch after a stint with PaineWebber, Inc. He completed the first OIQ for Merrill Lynch on December 21, 1995, stating that he had no outside business activity. At that time, he was unsure of his precise role with Siena Baja, describing it as "wannabe" rather than "formal." Tr. 71-72.

Although Siena Baja was formed on February 1, 1996, with his home address listed as the registered office and his name, as the registered agent, Moran again did not disclose any interest in the venture when he submitted the annual OIQ on February 15, 1996. Again, he was not sure of his exact role in the venture or its legal status. However, he made no effort to conceal his relationship in it. At some time after submitting the February OIQ and before updating that form in September 1996, Moran freely talked, at the Merrill Lynch office, about his involvement in the Baja Tortilla Grill venture, and, at the Merrill Lynch office, introduced Jones to his co-workers and a supervisor.

On September 25, 1996, Moran voluntarily updated his OIQ and, for the first time, reported an interest in Siena Baja, describing the business as a Mexican food restaurant franchise. He wrote that he had no "specific duties," because his role was not set, and he estimated the value of his sweat equity. He also discussed his involvement in the venture with the administrative manager of the branch office who signed the OIQ.

On February 26, 1997, Moran submitted another annual OIQ and, again, listed an interest in Siena Baja. Although, he did not specifically mention Baja Wyckoff, he noted that his business interest was in "Tortilla Grill, Mexican Restaurant." The OIQ form did not ask for information about compensation he may have received from any business interest.

Conduct Rule 3030 provides that no person registered with a member "shall be employed by, or accept compensation from, any other person as a result of any business activity…outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member . . . in the form required by the member." The purpose of Conduct Rule 3030 is to provide member firms with prompt notice of outside business activities so that the member's objections, if any, to such activities can be raised at a meaningful time and the member can exercise appropriate supervision as necessary under applicable law. *Proposed Rule Change by NASD Relating to Outside Business Activities of Associated Persons*, Exch. Act Rel. No 34-26063, 1988 SEC LEXIS 1841 (Sept. 6, 1988).

Moran's first written notice to Merrill Lynch of his involvement in Siena Baja was not given until nine months after he rejoined the firm. He made entries on all 11 lines that appear on the Merrill Lynch form, and accurately described the nature of the business as "'Tortilla Grill' Franchise (Mexican Food Concept) Restaurant." However, because that notice was not prompt, Merrill Lynch was not given a meaningful opportunity to review his activity and determine the

extent, if any, to which it should supervise his involvement. Accordingly, Moran violated Conduct Rules 3030 and 2110.[10]

SANCTIONS

For violation of Conduct Rules 2110 and 3030, the NASD Sanction Guidelines recommend a fine of $2,500 to $50,000, and, in certain cases,[11] a suspension for a period of 10 business days to one year. NASD SANCTION GUIDELINES, at 18. Citing what it considers to be aggravating circumstances, Enforcement seeks a fine of $12,500 ($2,500 plus the $10,000 in compensation that Moran received), a suspension of at least one month, and a requirement that he requalify by examination as a General Securities Representative. On the other hand, Moran acknowledges that the nature and timing of his disclosures to Merrill Lynch were inadequate and constituted violations of Conduct Rules 2110 and 3030. However, citing mitigating factors, the unique circumstances of the case, as well as the impact the investigation has had upon him, he asks that only minimal sanctions be imposed.

At the outset, the Hearing Panel finds that Moran's conduct was not venal. He was open about his involvement in the Baja Tortilla Grill venture, talking to his co-workers and a supervisor about it, and introducing them to Jones when he visited the office.[12] Moreover, he discussed his entire involvement in the venture with the administrative manager of the branch office at the time he voluntarily updated his OIQ in September 1996.

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[10] A violation of another NASD rule constitutes a violation of Conduct Rule 2110. *Steven J. Gluckman*, Exch. Act Rel. No. 41628, 1999 SEC LEXIS 1395 at *22 (July 20, 1999).

[11] "Where outside activity is similar to the employing firm's business, or activity presents a conflict of interest for the customer or employing firm."

[12] At the hearing, the NASD examiner testified as follows in response to a question by Moran's counsel:

Q. It's Mr. Moran's contention that he informed his supervisors about the nature of the outside business he was involved with. As you sit here today, do you have any information regarding a statement from a Merrill Lynch supervisor that would contradict that contention?

A. I do not have any statement that would contradict that.

Tr. 260.

The notice that Moran gave to Merrill Lynch in September 1996, although late, was substantively sufficient under Conduct Rule 3030. The notice requirements under Conduct Rule 3030 are less stringent than those required under Conduct Rule 3040. Where private securities transactions are involved, Conduct Rule 3040 requires that an associated person must include in the written notice to the member a detailed description of the proposed transaction and the person's proposed role in the transaction. Moreover, the person must state whether "he has received or may receive selling compensation in connection with the transaction." By contrast, where outside business activities are involved, the associated person need only provide written notice as required "in the form required by the member" before becoming employed by, or accepting compensation from, any other person as a result of business activity outside the scope of his relationship with his employer. Moran used the form required by Merrill Lynch and filled it out completely. It was sufficient to put Merrill Lynch on notice that he was involved in a restaurant franchise venture. To the extent that Merrill Lynch had need for information not sought by the form itself, the firm was free to inquire of Moran.

The format of the OIQ and Moran's entries would reasonably invite questions of anyone reviewing that September 1996 submission. On the line asking for specific duties of his "position," which Moran listed as "member of LLC," Moran answered "no specific duties." There was no structural "position" to which he had been appointed, nor was he assigned to specific duties in the evolving venture. There was not enough room on the single line of that entry to explain what he was doing for the entity Siena Baja, as contrasted with the recently formed entity Baja Wyckoff. He listed the amount of his financial interest as "currently" not applicable, and the date of acquisition of financial interest, as "pending." Those responses

indicated that a financial interest was a possibility in the future.[13] Again, a detailed response would require more than a single line and could only be fully understood in the context of background factual information. Taken together with Moran's testimony, the format of the form and the entries on it make it more likely than not that a fairly wide ranging discussion occurred between Moran and the administrative manager who signed the OIQ.

Moran did not engage in his outside activities in the face of any disapproval of those activities by Merrill Lynch, nor did he attempt to create the impression that Merrill Lynch sanctioned those activities. Neither factor, then, is aggravating.

From and after February 1997, Moran received compensation for assuming the role previously filled by Thompson. Moran's outside activities also involved an enterprise in which he had a proprietary or beneficial interest. Certainly, Moran sought to have such an interest, and on two OIQs he gave an estimate of what he thought his sweat equity was worth. However, because the venture failed, and he was left to pay $25,000 on the guarantee of the lease for the restaurant, that interest turned out, in reality, to be a liability. The outside activity listed on the February 1997 OIQ, on which he disclosed his estimated financial interest, was eventually approved by Merrill Lynch. CX 26. The Hearing Panel also does not find that the receipt of compensation should have been disclosed when first received in February 1997. The form does not specifically call for that information, and Conduct Rule 3030 requires only such information as is required by the member firm's form.

Two of the four Investors in Baja Wyckoff were customers of Merrill Lynch. That factor is aggravating. However, their investments were in a Mexican fast-food restaurant, a business opportunity, not a financial product. Moreover, A.L., who had known Moran since his

[13] On the February 1997 OIQ, Moran disclosed that he acquired a financial interest in the venture in November 1996. CX 25.

childhood, first learned of the venture from her accountant, Jones. D.M. had been a long time personal friend of Moran, before he had opened a securities account with him. Moran never attempted to create the impression with either of them that Merrill Lynch sanctioned his activity. Their dealings with Moran were as personal friends interested in a business opportunity, not as customers buying a product that would produce commissions or fees for Moran.

At the hearing, Moran was contrite. He credibly testified that he accepted responsibility for his conduct and acknowledged that it violated Conduct Rules 2110 and 3030. In December 1999, Merrill Lynch terminated his employment and his once promising career at that firm. Since that time, he has been living on his retirement savings and, at the present time, is practically broke. Tr. 273-78.

Conclusion

Balancing the foregoing factors, and determining sanctions that are remedial, but not punitive, the Hearing Panel concludes that Moran should be fined $5,000, and suspended from associating in any capacity with a member firm for a period of 10 business days for engaging in outside business activities without providing his member firm with prompt written notice, in violation of Conduct Rules 3030 and 2110. Given the circumstances of this case, the Hearing Panel believes that these sanctions are sufficient to deter future misconduct and improve the overall business standards in the securities industry.

These sanctions shall become effective on a date set by NASD, but not earlier than 30 days after the date this decision becomes the final disciplinary action of NASD, except that if this decision becomes the final disciplinary action of NASD, the suspension shall become

effective with the opening of business on Monday, September 16, 2002, and end at the close of business on Friday, September 27, 2002.

SO ORDERED.

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Alan W. Heifetz
Hearing Officer
For the Hearing Panel

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