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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	
Complainant,	Disciplinary Proceeding No. CAF000027
v.	Hearing Officer - AWH
Respondent 1	**Hearing Panel Decision**
	November 27, 2002
Respondent 2	
Respondents.	

Registered representative and trader found not liable for participating in or facilitating violations of Section 10(b) of the Exchange Act and Rule 10b-6 thereunder, and NASD Conduct Rule 2110. Registered representative and principal found not liable for failure to supervise, in violation of NASD Conduct Rules 2110 and 3010, and not liable for improper cancellation of customer orders, in violation of NASD Conduct Rule 2110. Complaint against both Respondents dismissed.

Appearances:

Jeffrey P. Bloom, Esq., and Robert W. Turk, Esq., for the Department of Enforcement

EH, Esq., for Respondent 1

RR, Esq., for Respondent 2

DECISION

Introduction

On November 1, 2000, the Department of Enforcement ("Enforcement") filed a nine-cause Complaint in this matter against Respondent 3, ("Respondent 3"), Respondent 4 ("Respondent 4"), Respondent 1 ("Respondent 1"), and Respondent 2 ("Respondent 2"), alleging violations of the anti-fraud provisions of the federal securities laws and NASD Conduct Rules. The alleged violations occurred in connection with the initial public offerings ("IPOs") and aftermarket trading in 1996 of Sound Source Interactive, Inc. ("Sound Source") and Chicago Pizza and Brewery, Inc. ("Chicago Pizza"), two NASDAQ Small-Cap issues. On March 22, 2001, Enforcement filed an Amended Complaint, adding a tenth cause against Respondent 4 and Respondent 2 that alleged a violation of NASD Conduct Rule 2110 in connection with the April 1997 IPO and aftermarket trading of Scoop, Inc. ("Scoop"), an OTC Bulletin Board issue. For purposes of this Decision, references to the "Complaint" will refer to the Amended Complaint, unless otherwise specified. Also on March 22, 2001, Enforcement withdrew the Complaint against Respondent 3.

Respondent 4, Respondent 1, and Respondent 2 filed Answers to the Complaint, denying the alleged violations, and each requested a hearing. Respondent 2 filed an Answer to the Amended Complaint, denying the additional alleged violation. On September 14, 2001, the proceeding was stayed due to the tragic events of September 11, 2001. A hearing was held in Los Angeles, California, on May 6–9, 2002, before an extended hearing panel composed of the Hearing Officer and two former members of District No. 3.

Because Respondent 4 failed to participate in pre-hearing conferences and failed to appear at the hearing, Enforcement moved for a default order against him. The Hearing Officer granted that motion and, as a result, the Hearing Officer is issuing a separate Default Decision against Respondent 4, which is being served concurrently with this Decision.[1] This Decision will refer to Respondent 4's role in the IPOs and aftermarket trading of the three issues, but it resolves the allegations in the Amended Complaint against only Respondent 1 and Respondent 2. During the hearing at the close of Enforcement's case, Respondent 2 moved for judgment and Respondent 1 moved for partial judgment against Enforcement. The hearing panel denied Respondent 2's motion. The hearing panel granted Respondent 1's motion, finding that there was no evidence that Respondent 1 knowingly violated any anti-fraud provisions of the federal securities laws or NASD Conduct Rule.[2] At the conclusion of the evidence, counsel for Respondent 1 presented an oral argument in lieu of a post-hearing written submission. Enforcement and Respondent 2 filed Post-Hearing Briefs on July 29, 2002.

Summary of the Allegations in the Complaint

Nine of the ten causes in the Complaint allege violations by Respondent 4 involving the distribution of stock and warrants. Causes Two and Six are the only causes that allege violations by Respondent 1. They allege that Respondent 1 participated in, and facilitated some of the violations by Respondent 4. Respondent 2 is also named in only two causes. Cause Nine alleges a supervisory violation by Respondent 2, and cause Ten alleges that, together with Respondent 4, he improperly cancelled certain customer trades.

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[1] The Default Decision finds Respondent 4 liable for (1) bidding for, purchasing, and inducing others to purchase warrants while engaged in secondary distributions, in violations of Section 10(b) of the Exchange Act and Rule 10b-6 thereunder, and NASD Conduct Rule 2110; (2) failing to comply with NASD Corporate Financing requirements and receiving unfair and unreasonable underwriting compensation, in violation of NASD Conduct Rules 2110 and 2170; and (3) improperly canceling customer orders, in violation of NASD Conduct Rule 2110.

[2] The motions and rulings appear at pages 508-19 of the hearing transcript.

Cause One – Purchase and Sale of Securities During a Continuing IPO Distribution

The Complaint alleges that Respondent 4 continued to sell Sound Source IPO warrants and common stock to customers even though Respondent 3 had purportedly completed the distribution and ceased all IPO selling efforts; that Respondent 3, acting through Respondent 4, did so while Respondent 3 was acting as a market maker and bidding for, purchasing, or inducing others to purchase the securities in the immediate aftermarket at substantially higher prices; and that Respondent 3, through Respondent 4, fully exercised the IPO over-allotment option, obtaining more warrants and shares than were needed to cover any short position in Respondent 3's syndicate account. By so doing, the Complaint alleges that Respondent 4 violated Section 10(b) of the Exchange Act and Rule 10b-6 thereunder, and NASD Conduct Rule 2110.

Cause Two – Purchase and Sale of Securities During a Secondary Distribution

The Complaint alleges that in the immediate aftermarket, Respondent 3, through Respondent 4, bought large amounts of Sound Source warrants from Selling Security Holders, and, using special selling efforts, caused Respondent 3's registered representatives to resell those warrants to Respondent 3's retail customers at significantly higher aftermarket prices. The Complaint also alleges that Respondent 1, Respondent 3's "head" trader, knew or should have known that Respondent 3 was engaged in a secondary distribution of Sound Source warrants, and that he directly participated in and facilitated the violations by Respondent 3 and Respondent 4 of Section 10(b) of the Exchange Act and Rule 10b-6 thereunder, and NASD Conduct Rule 2110.

Cause Three – Failure to File Documents and Receipt of Excessive Underwriting Compensation

The Complaint alleges that Respondent 4 violated Conduct Rules 2110 and 2710 by failing to file certain information and documents regarding the proposed terms of the secondary distribution of Sound Source warrants with the Corporate Financing Department of NASD, and that Respondent 3, through Respondent 4, received underwriting compensation that was unfair and unreasonable.

Cause Four – Fraudulent Omissions of Material Fact

The Complaint alleges that Respondent 4 knowingly or recklessly caused Respondent 3 and its registered representatives to fail to disclose to Respondent 3's retail customers certain material information with respect to the Sound Source IPO and the purchase and sale of Selling Security Holder warrants, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120.

Causes Five, Six, Seven, and Eight

The Complaint alleges the same violations as those in the first four causes in the Complaint, but these causes relate to the IPO and aftermarket sales of Chicago Pizza warrants and common stock. The pattern with regard to the Chicago Pizza warrants, however, involved short sales by Respondent 3, with covering purchases from Selling Security Holders.

Cause Nine – Failure to Supervise

The Complaint alleges that Respondent 3, through Respondent 2, failed to establish, implement, and enforce written supervisory controls or procedures for Respondent 3's investment banking, underwritings, and aftermarket trading, in violation a NASD Conduct Rules 2110 and 3010.

Cause Ten – Improper Cancellation of Customer Orders

The Complaint alleges that, minutes after the opening of aftermarket trading in Scoop common stock, the managing underwriter, SG, released for sale the Scoop common stock held by the Selling Security Holders; that Respondent 3, through Respondent 4, purchased from Selling Security Holders and resold large amounts of Scoop stock while Respondent 3 was acting as a market maker in the stock; that over the next five days, SG rescinded the release of the lockup of all but a relatively small portion of the Selling Security Holders shares; and that as a result of the rescission of the lockup, Respondent 4 and Respondent 2 unilaterally cancelled Respondent 3 retail customers' purchases of Scoop shares while such shares remained available in the aftermarket.

General Findings of Fact[3]

DESCRIPTION OF RESPONDENT 3, RESPONDENT 4, AND THE RESPONDENTS

Respondent 3

Respondent 3 was an NASD registered broker-dealer that began operations in March 1995. Its main office was in Los Angeles, California, and it maintained one branch office in Boston and two in New York City. Respondent 3 was a limited partnership whose general partner was a corporation (BP) owned entirely by Respondent 4. Tr. 784-85. The limited partner was a limited liability company known as Respondent 3, LLC ("the LLC"). BP, Incorporated, managed the LLC, and Respondent 4's share of the LLC's capital account was $3,271,377 out of a total capital account of $4,639,408. RHX 30. In September 1998, Respondent 3 terminated its business, filed a Form BDW, and withdrew its membership in NASD. Complaint, ¶ 15.

Respondent 4

In July 1996, Respondent 4 was the 36 year-old Chairman, chief executive officer, and, through his ownership of BP, Inc., general partner of Respondent 3. He first entered the securities business in 1985 as a registered representative with Shearson Lehman Bros., Inc. He subsequently worked as a registered representative with Gruntal & Co., Inc., D. H. Blair & Co.,

[3] References to Enforcement's exhibits are designated as CX_; Respondent 1's exhibits, as RX_; Respondent 2's exhibits, as RHX_; and the transcript of the hearing, as Tr._.

Inc., and A. S. Goldmen & Co., Inc. In December 1993, while employed at A. S. Goldmen, he became a general securities principal and was promoted to branch manager of the firm's Los Angeles office. In September 1994, he formed Respondent 3 and became licensed as a general securities representative and principal of the firm. He is not currently registered with any firm. Complaint, ¶16; CX 2; Tr. 60-61.

The largest shareholder in Respondent 3, Respondent 4 handled the retail side of the firm's syndication and corporate financing activities. Tr. 333. The heads of the Syndicate and Corporate Finance departments reported directly to him. Tr. 333-34. He also controlled all activities in the trading room on issues in which Respondent 3 made a market, including the positions the firm took, the size of those positions, and the bid and ask prices the firm would quote. Tr. 245-53, 443, 468, 656-58, 681-82, 726-27, 756. He also controlled retail sales. As one registered representative stated, "If [Respondent 4] wasn't controlling who you spoke to and what you said, you were not welcome to work in his office." CX 109, at 10. The firm's Director of Finance stated:

> . . . any big decisions, any medium decisions, a lot of time even little decisions were - and I'm not trying to throw him under the bus here just to prove this. It was Respondent 4. It was his firm. I mean he was the guy that had most of the stock. He had supplied the capital. He called the shots. He would take everyone's advice, but in the end, the buck stopped with him."

Tr. 696-97.

<u>Respondent 1</u>

In 1996, Respondent 1 was a 28 year-old general securities representative and trader at Respondent 3. He entered the securities industry in 1991, working at Merrill Lynch. In 1993, he became a clerk on the trading desk at J. Alexander Securities, Inc. where he met KJ, the future vice-president of trading at Respondent 3. In April 1995, KJ recruited Respondent 1 to work at Respondent 3. At the time of the hearing, Respondent 1 had been laid off from his last position with a broker-dealer and was not working at all. CX 3; 523-33.

In 1996, Respondent 1's base salary at Respondent 3 was $50,000, and his total compensation for that year, including a bonus, was $70,000. Tr. 538-39. Although he described himself as a "market maker" both for stocks that Respondent 3 took public and those in which retail brokers had an interest, he did not manage a trading account, nor did he have discretion to trade for the benefit of Respondent 3. He did not share personally in any profits or losses from trading on a principal basis. He received no additional compensation for work he did as a trader in the Sound Source or Chicago Pizza IPO aftermarket. Tr. 538-41.

Respondent 1 would speak to Respondent 4 about trading issues between 5 and 20 times a day, either face-to-face, or by a special phone hook-up that was a direct line to Respondent 4's office. Tr. 542-43. Prior to the Sound Source and Chicago Pizza IPOs, Respondent 1 had been involved in four other IPOs at Respondent 3. In all four, Respondent 1 did not become involved prior to the commencement of aftermarket trading, nor did he speak to anyone in Corporate Finance, Operations, or on the retail brokerage staff about upcoming IPOs. In all four, Respondent 4 decided what the opening bid and ask prices would be; whether the firm would go long, short, or remain flat in the newly registered stock; how large a position the firm would take in the stock; and whether and when to change the firm's price quotes on the stock. Respondent 1 had no discretion to overrule Respondent 4's instructions. Tr. 544-45, 55, 59-61.

Respondent 1 was not told by anyone that there would be anything different about the Sound Source or Chicago Pizza offerings. Tr. 562-64. He did not review any prospectus for either offering, nor was he aware that there were alternate prospectuses relating to the Selling

Security Holder[4] securities in those offerings. Tr. 565-67. At the time aftermarket trading began for those offerings, he was not aware of the registration of securities other than those being issued in conjunction with the IPOs. Tr. 568. Respondent 4 made all decisions as to price quotes, establishing positions, and size of positions. Respondent 1 followed Respondent 4's instructions, mechanically entering numbers into the NASDAQ system. Tr. 245-53, 569-72. Respondent 1 knew that Respondent 4 always gave sales credits to brokers on IPOs, as well as price improvement to the firm's customers. Tr. 587-88. Respondent 4 did not discuss trading strategy with Respondent 1, or disclose to Respondent 1 how he intended to cover short positions. Tr. 591. No one at Respondent 3, including KJ, Respondent 1's supervisor, told or suggested to Respondent 1 that there might be a potential securities law violation occurring as a result of aftermarket trading in either Sound Source or Chicago Pizza. Tr. 578.

<u>Respondent 2</u>

Respondent 2 was, at all times relevant to the Complaint, Vice-Chairman and a general securities representative and principal of Respondent 3. For nearly 20 years, he was employed by NASD in three different offices, occupying increasingly senior positions, including Vice-President and District Director. In 1992, he left NASD to become President and CEO of a holding company. In 1994, he joined Respondent 4 in establishing what was to become Respondent 3. Complaint, ¶18. Respondent 4 supplied the money, and Respondent 2 did all the work necessary to establish Respondent 3 as a broker-dealer and a member of NASD. He arranged to retain the services of a clearing firm, and he wrote supervisory procedures for the firm. Respondent 2 also served as the executive representative of Respondent 3 for purposes of

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[4] Selling Security Holders are those who obtained their warrants pursuant to an investment in an earlier private placement that Respondent 3 had arranged for Sound Source and Chicago Pizza.

communicating with NASD. Tr. 785-89. From March to December 1995 he performed the functions of the Director of Compliance for the firm, until JK assumed that position in January 1996. Tr. 801. He is not currently registered with any firm. Tr. 62-63.

Findings of Fact Regarding Distributions

I. THE SOUND SOURCE OFFERING

Sound Source was engaged in the business of developing and marketing interactive educational computer software for children. In anticipation of its IPO, Sound Source registered 2,400,000 shares of common stock and 1,200,000 warrants. The company also registered an additional 500,338 shares of common stock and 5,689,665 warrants for the benefit of certain Selling Security Holders, which were not included in the IPO. The offering included an over-allotment option[5] consisting of 360,000 shares and 180,000 warrants. CX 36, at 1, 7, 9. The registration statement included two prospectuses: an IPO prospectus and an alternate prospectus for the Selling Security Holder securities. CX 36, 56. The alternate prospectus noted that "[i]t is anticipated that a significant amount of the shares of Common Stock and substantially all of the Redeemable Warrants being offered hereby [stock and warrants held by the Selling Security Holders] will be sold to customers of the Underwriters." CX 56, at 18.

The Sound Source IPO was declared effective on July 2, 1996. CX 36; Tr. 120. Respondent 3 was the lead underwriter in the firm commitment offering, and JS & Co. ("JS") served as co-underwriter. Each underwriter received equal shares of the IPO securities. The public offering price of the Sound Source securities was $4.00 per share and $.25 per warrant. CX 36. Respondent 3 formed a selling group and shared 134,000 IPO shares of common

[5] An over-allotment option provides for additional shares that may be distributed if there is an exceptional demand for the offering.

stock and 67,000 IPO warrants with 11 broker-dealers. CX 37. Aftermarket trading in Sound Source began at approximately 2:20 p.m. on July 2, 1996. CX 60.

Aftermarket trading

When aftermarket trading began, Respondent 4 came into the trading room and handed a stack of buy tickets to Respondent 1, telling him to execute them. Tr. 603-04. Within the first three minutes of aftermarket trading on July 2, 1996, Respondent 3 purchased 3,050,000 warrants from Selling Security Holders. CX 60; Tr. 126. Respondent 4 was the account executive named on tickets for 2,600,000 of the 3,050,000 warrants on which Respondent 3 was long. Most of Respondent 4's tickets were in blocks of 50,000 to 100,000 warrants; one was for 600,000. CX 60, 63. Three of Respondent 4's tickets and six of the other tickets were initialed by KJ as the "Manager." Respondent 3 remained on the inside bid for most of the day. CX 59. Although Respondent 1 had seen Respondent 3 take long or short positions on numerous previous occasions, he characterized trading in Sound Source as unusual because of the size of the long position. Tr. 584, 595. The purchases were placed in Respondent 3's private placement account. Respondent 1 knew about the existence of that account, although he was unaware of its function or purpose. Tr. 606-07.

Respondent 3 purchased the warrants for $.95 or $1.00, when the inside bid had risen in the first minute of trading to $1.50 and the inside ask to $1.75. CX 59, 60. That same day, Respondent 3 sold 827,725 Selling Security Holders warrants to retail customers at aftermarket prices, but generally below the inside ask of $2.25 to $2.38. *Id.* On July 3, 1996, Respondent 3 purchased an additional 375,000 Selling Security Holder warrants, and sold 360,950 warrants. *Id*. Over the period July 2 through 25, 1996, Respondent 3 purchased and sold approximately 3,425,000 Sound Source Selling Security Holder warrants. Of that total, 1,758,900 were sold to retail customers, 1,500,000 were sold to broker-dealer JS, and 166,100 were sold to four other dealers. CX 62; Tr. 127-28. Respondent 3's registered representatives received a sales credit averaging nearly 24% of the total amount paid by retail customers. CX 69.

Excessive Compensation

After NASD's Corporate Financing Department reviewed information submitted by Respondent 3 for the Sound Source offering, on February 1, 1996, it requested assurances in the form of written undertakings that Respondent 3 would file a post-effective amendment to the disclosures in the Selling Security Holder prospectus, and file an estimate of maximum compensation to be received, if anything more than ordinary brokerage commissions[6] were to be received by Respondent 3 from the offering. CX 57; Tr. 377. No post-effective amendment was filed by Respondent 3, nor did it file an estimate of maximum compensation to be received. Tr. 377-78. Had it filed the appropriate information, NASD's Corporate Financing Department would have found that, from the distribution of Sound Source warrants, Respondent 3 made $2,021,491 in underwriting compensation, of which $1,348,560 was excessive.[7] CX 71; Tr. 131, 379.

Alleged Continuing Distribution of IPO Securities

Enforcement presented exhibits purporting to show that, at the end of the first day of aftermarket trading, Respondent 3 had sold 536,474 IPO warrants to customers, exceeding its entire IPO retail allocation and leaving it with a short position of 3,474 warrants (CX 52), and that it had distributed 997,000 shares of common stock, leaving it with a long position of 69,000

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[6] NASD Rule 2440 typically limits such compensation to 5% or less. Tr. 388.

[7] The compensation Respondent 3 received also exceeded the amount allowed under the mark-up policy of NASD Rule 2440.

unsold shares in the syndicate account (CX 44). Enforcement then alleged that, over the next three days, Respondent 3 sold an additional 186,200 IPO warrants and 343,900 IPO shares to customers at the public offering price (CX 51, 52). Finally, Enforcement alleged that approximately six weeks after the last "late" sale of IPO stock and warrants, Respondent 3 exercised the green shoe[8], acquiring an additional 180,000 warrants and approximately 180,000 shares (CX 37, 39). Enforcement alleged that these additional securities were not needed to cover what it claims was a short position of 3,624 warrants in Respondent 3's syndicate account (CX 52).

The Hearing Panel does not find Enforcement's allegations of fact to be proved. All of Enforcement's allegations with regard to a continuing distribution of IPO securities rest on documents it prepared, based on trade *process* dates. CX 43. That information was obtained from the "blue sheets," electronically downloaded from Respondent 3's clearing firm. Tr. 79. However, like the IPO trades for Chicago Pizza, below, the IPO trades for Sound Source were billed "as of" the last day of IPO trading. *See* Tr. 93. The atmosphere in the Respondent 3 trading room at the beginning of trading of an IPO was described as "pandemonium," "crazy," "chaotic," and "guys . . . going nuts." Tr. 572-73, 655, 729. For the Sound Source IPO, trading began on the Tuesday after the Friday that Respondent 3 moved into a brand new facility. Phones, computers, and office systems had to be set up and tested within one business day of doing the underwriting. Tr. 853. The normal frenzy in the trading room at the commencement of an IPO could only have been exacerbated by the move to new office space and the reinstallation of communications and computer hardware. Moreover, there was no testimony from any

[8] A green shoe is a provision in an underwriting agreement that the issuer will authorize additional shares for distribution by the underwriter if there is an exceptional public demand for the offering. NASDR GLOSSARY OF INVESTING TERMS.

customer, or anyone else, that a purchase or sale of Sound Source IPO securities was made after the commencement of aftermarket trading. Accordingly, the Hearing Panel finds that, on this record, Enforcement did not prove that IPO trading took place after the commencement of aftermarket trading. The evidence demonstrates an equal likelihood that the paper work was backed up and could not be processed prior to the commencement of aftermarket trading. *Cf*. CX 109, at 13 (processing backup on Chicago Pizza IPO).

II. THE CHICAGO PIZZA OFFERING

Chicago Pizza develops, owns, and operates restaurants featuring pizza and other foods. Some of its restaurants operate in a micro-brewery environment where proprietary beers are produced on-site. CX 5, at 5. Prior to an actual IPO, Respondent 3 entered into two agreements to raise capital for Chicago Pizza. In September 1995, Respondent 3 agreed to arrange a private placement for the company involving 6,000,000 warrants. In February 1996, Respondent 3 obtained additional financing for the company through a bridge loan, whereby a certain customer invested $1 million in exchange for a note that would convert into 250,000 shares of common stock and 1,500,000 warrants. *Id*., at 65.

In anticipation of conducting an IPO, Respondent 3 filed a registration statement with the SEC that provided for the issuance and sale of 1,800,000 shares of common stock and 1,800,000 warrants. *Id*. The registration statement also provided for a green shoe consisting of an additional 270,000 warrants. At the same time, Respondent 3 filed an alternate prospectus pursuant to the same registration statement for the benefit of certain Selling Security Holders. Through this alternate prospectus, an additional 1,766,864 shares and 10,014,584 warrants were registered, but were not included in the IPO. CX 22. Both the initial and alternate prospectuses noted that "[a]lmost all of the Selling Security Holders are clients of the Representative

[Respondent 3] and are obligated to sell their respective Securities through the Representative." CX 5, at 20, CX 22, at 17.

On October 8, 1996, the Chicago Pizza IPO became effective. CX 5. Respondent 3 was the sole underwriter in the "firm commitment" offering. The public offering price of the securities was $5.00 per share and $.25 per warrant. *Id*. Respondent 3 immediately allocated 392,200 warrants and 432,200 shares to a broker-dealer group. CX 10. The offering was a hot issue.[9] Tr. 165. After determining that its retail allocations were complete, Respondent 3 contacted NASDAQ Market Operations to release the security for aftermarket trading, which commenced at 2:30 p.m. on October 9, 1996. CX 24.

Aftermarket Trading

Respondent 3 began selling warrants almost as soon as aftermarket trading began. By 3:58 p.m., it had accumulated a short position of 945,650 warrants. The vast majority of sales were executed at a price of $1.625. CX 25. The inside ask, with the exception of 17 minutes when it was at $1.50, was from $1.75 to $2.00. CX 24. Respondent 3 was never on the inside ask for aftermarket trading on October 9. *Id*. This short position was covered largely by two block purchases totaling 737,500 warrants, at $1 per warrant, from Selling Security Holders at 3:59 and 4:01 p.m. CX 25, at 5. Except for the first two minutes of trading, the inside bid was between $1.1250 and $1.25. CX 24. Respondent 4 was the account executive shown on the tickets for both purchases. CX 28. At least one of those tickets was initialed by KJ as "Manager." CX 28. On the second day of aftermarket trading, at 11:38 a.m., Respondent 3's short inventory position increased to 477,400 warrants when, in the same minute, it covered a

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[9] A "hot issue" is one that is in great demand, and the price of the stock usually shoots up at its initial offering. NASDR GLOSSARY OF INVESTING TERMS.

portion of that position by purchasing a block of 150,000 warrants, at $1.0625 per warrant, from a Selling Security Holder. CX 25, at 7. The vast majority of sales to its retail customers that morning were at $1.625. *Id*., at 5-7. At 3:52 p.m., its short inventory position increased to 611,225 warrants, before it bought 650,000 warrants, at $1 per warrant, in two blocks from Selling Security Holders at 3:59 p.m. *Id*., at 9. Respondent 3 sold warrants after 11:38 and before 3:52 for between $1.0625 and $1.625. *Id*., at 7-9. It was never on the inside ask of between $1.50 and $1.75. CX 24. Respondent 4 was the account executive shown on the tickets for both block purchases, and KJ initialed the tickets as "Manager." CX 28, at 3.

Respondent 3's sales representatives received a sales credit averaging 29.17% of the total amount paid by the customer. CX 32. In its post-hearing submission, Enforcement avers that Respondent 4 "pressured registered representatives to build massive positions in the securities the firm was underwriting, and actually *discouraged* them from selling any other securities" (emphasis in the original). To substantiate that allegation, Enforcement offered the Transcript of Interview of JB ("JB Transcript"), CX 109. However, the Hearing Panel does not find the JB Transcript to be reliable evidence.[10] JB, a former Respondent 3 registered representative, did not testify at the hearing in this proceeding; there is no indication that JB reviewed and approved the transcript as accurate; he was not subject to cross-examination by counsel for Respondents in this proceeding; and, in view of the caption of the Transcript, "An Examination of the Termination Notice Filed by Respondent 3 on JB," the Hearing Panel has no way to determine whether JB had reason to be biased against Respondent 3 or any Respondent in this proceeding as a result of his apparent termination. Finally, the statements in the JB Transcript were contradicted by PS, a

[10] *See Vincent J. Puma*, No. C10000122, (NAC October 21, 2002) (Remand Order) (factors used to assess reliability of hearsay evidence include: possible bias of declarant; whether direct testimony is contradictory; type of hearsay; whether declarant was available to testify; and whether hearsay is corroborated) (citations omitted).

broker, limited partner, and managing director of Respondent 3, who testified that he knew of no special or unusual efforts to get brokers to sell warrants for either the Chicago Pizza or Sound Source offerings. Tr. 761-62. Assessing his testimony and demeanor, the Hearing Panel found PS to be credible. There was no evidence that he had any reason not to be candid in his testimony.

As with the Sound Source offering, Respondent 1 entered orders and maintained Respondent 3's positions in the Chicago Pizza offering at Respondent 4's direction. Tr. 597. Because Respondent 3 often took long or short positions in securities it held for its own account, Respondent 1 did not find the short position that Respondent 4 took in Chicago Pizza to be unusual. Tr. 629. He was aware that customers were being given price improvement, and that brokers were receiving sales credits on the offering, but he did not find that to be unusual at Respondent 3. Tr. 585-87, 629. When he expressed his concern to Respondent 4 about the size of the firm's short position, Respondent 4 said "I'll try to find you some stock." Tr. 620. KJ also found nothing unusual about the way Respondent 4 participated in trading the Chicago Pizza offering, or the way price improvement or sales credits were handled. Tr. 458-59. Neither did another trader, PM. Tr. 660-62. According to PM, Respondent 4 was in the trading room "[t]o control everything that was going on . . . [he] called the shots." Tr. 656, 59. However, PM did find it unusual that Respondent 3 took such large positions in the Sound Source and Chicago Pizza offerings. Tr. 664. In his trading for the firm, he tried to remain flat at the end of the day, although, after conferring with Respondent 4, he might maintain an overnight position of no more than 1,000 shares. Tr. 663-64.

Excessive Compensation

Respondent 3 assured the NASD Corporate Financing Department, as it did with regard to Sound Source, that it would file a post-effective amendment to the disclosures in the Selling Security Holder prospectus, and file an estimate of maximum compensation to be received. Tr. 383. No post-effective amendment nor estimate of maximum compensation was received by NASD. *Id*. Had Respondent 3 filed the appropriate information, the NASD Corporate Financing Department would have found that, from the distribution of the Selling Security Holder's Chicago Pizza warrants, Respondent 3 made $834,068, an amount that exceeds maximum underwriting compensation for an offering of this size by nearly $470,000. CX 34; Tr. 115, 386.

Alleged Continuing Distribution of IPO Securities

Enforcement alleged that Respondent 3 was unable to sell its entire allocation of Chicago Pizza shares and warrants by the time aftermarket trading began on October 9. However, as was the case with Sound Source, trades after October 9 were all billed "as of" October 9, and Enforcement's case rests on documents it prepared, based on trade process dates that were obtained from the clearing firm's final allocation sheets. CX 12, 17; Tr. 79-80, 93. Enforcement prepared a document that purports to show that from October 9 to November 7, 1996, there were 715 new IPO transactions totaling 759,900 shares. CX 14; Tr. 87. However, of those totals, 675 new transactions totaling 720,550 shares were processed on October 10 and 11, 1996. CX 14. There is no evidence upon which the Hearing Panel can determine which, if any, of those "new" transactions were trades entered into, rather than merely processed, after the commencement of aftermarket trading. Because Respondent 3 was "swamped" with tickets during the IPO, the final allocation sheets were sent late to the clearing firm. CX 105, at 26. CX 14 shows 40 new transactions totaling 39,350 shares from October 14 through November 4, 1996. Because of the timing of those transactions, they may have been entered into after the commencement of aftermarket trading. However, the only reliable evidence of a trade entered into after October 9 is the stipulated testimony of customer RF who initially purchased Chicago Pizza IPO shares and warrants on October 9, 1996, and again purchased warrants the next day when a Respondent 3 registered representative called him to offer additional warrants at the initial public offering price of $.25 per warrant, when they were trading at the same time for $1.00 in the aftermarket. Tr. 475-76.

Enforcement also alleged that Respondent 3 exercised the green shoe on November 21, 1996, to obtain 270,000 additional warrants, although the firm's syndicate account was long over 900,000 warrants at the close of the first day of aftermarket trading. Enforcement's Brief, at 12. However, because Enforcement's calculation of the long position was based on trade *process* dates rather than evidence of when the trades actually took place, and because exhibits CX 9 and 10 suggest that the firm may have been short 14,400 warrants after the exercise of the green shoe, the Hearing Panel cannot make the finding that Respondent 3 exercised the over-allotment option to obtain more warrants than were needed to cover any short position in its syndicate account. *See* CX 9, at 5; CX 10, at 4, 5; Tr. 93.

Discussion of Alleged Distribution Violations

I. The SOUND SOURCE AND CHICAGO PIZZA "DISTRIBUTIONS"

Rule 10b-6 Definition and Elements

SEC Rule 10b-6 provides that it shall constitute a manipulative or deceptive device or contrivance for an underwriter to bid for, purchase, or induce others to purchase a security while still participating in the distribution of that security. 17 CFR § 240.10b-6.[11] Rule 10b-6 is designed to prevent persons participating in the distribution of a security from artificially conditioning the market in order to facilitate the distribution, and to protect the integrity of the securities trading market as an independent pricing mechanism. *Review of Antimanipulation Regulation of Securities Offerings*, Exchange Act Rel. No. 33924 (April 19, 1994), 1994 SEC LEXIS 1302.

The term "distribution" is defined in Rule 10b-6(c)(5) as "an offering of securities that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." The relevant factors in evaluating the magnitude of the offering are the number of shares for sale, and the percentage of outstanding shares of the public float, and the percentage of the trading volume, that those shares represent. *Id*. Providing greater than normal sales compensation arrangements pertaining to the distribution of a security is indicative of special selling efforts and selling methods. *Id*.

<u>The Sound Source Distribution</u>

From July 2 through 25, 1996, Respondent 3 purchased and sold 3,425,000 Sound Source Selling Security Holder warrants, amounting to 48.4% of the total warrants issued and outstanding. Respondent 3 sold approximately half of those warrants to retail customers.[12] Respondent 3's purchase and sale of almost 3.5 million Selling Security Holder Warrants satisfies the magnitude requirement of Rule 10b-6. *See A.S. Goldmen & Co., Inc*., Exchange Act

[11] In December 1996, a few months after the conduct at issue occurred, the SEC adopted Regulation M to replace Rule 10b-6 and certain other Rules. Exchange Act Rel. No 38,067 (Dec. 20, 1996), 63 SEC Docket 1374. Regulation M did not change the substance of the requirements under Rule 10b-6.

[12] 1,200,000 warrants offered in the IPO + 180,000 over-allotment warrants, + 5,689,665 warrants registered through the Selling Security Holder prospectus = 7,069,665 total warrants.

Rel. No. 44328, 2001 SEC LEXIS 966 (May 21, 2001) (more than 36% of the total number of warrants issued and outstanding was of sufficient magnitude to qualify as a distribution).

Special selling efforts and selling methods may be demonstrated by the payment of compensation greater than that normally paid in connection with ordinary trading transactions. *Review of Antimanipulation Regulation of Securities Offerings,* 1994 SEC LEXIS 1302, at *24. Here, Respondent 3's registered representatives received a sales credit averaging nearly 24% of the total amount paid by retail customers. A sales credit of that magnitude exceeds, by a factor of more than four, the amount allowed under the mark-up policy of NASD Rule 2440. Accordingly, the Hearing Panel finds it to be presumptively excessive and outside of what could be considered as normal for ordinary trading transactions. No evidence was introduced upon which the Hearing Panel could find that the sales credit was not excessive under the circumstances. *Cf. A.S. Goldmen & Co., Inc*., 2001 SEC LEXIS 966, at *28 (commission equal to 24.31% of total sales price found to be greater than that normally paid in connection with ordinary trading transactions).

Based on the magnitude of the offering and Respondent 3's special selling efforts, the Hearing Panel concludes that Respondent 3's purchase and sale of Sound Source warrants constituted a distribution.

<u>The Chicago Pizza Distribution</u>

Respondent 3, through Respondent 4, had a substantial interest in the success of a distribution of Chicago Pizza Selling Security Holder warrants, and took active steps to affect the price of the warrants. According to the prospectus, almost all of the Selling Security Holders were clients of Respondent 3 and were obligated to sell their warrants through Respondent 3. No one in the trading room received a copy of the prospectus, but Respondent 4 knew that the

Selling Security Holders had to sell through him. Respondent 3 was the sole underwriter in the offering, and Respondent 4 was the account executive shown on the block purchases from the Selling Security Holders. In the first hour and a half of aftermarket trading, Respondent 3 amassed a short position of 945,650 warrants, which was then covered, in the following three minutes, by two block purchases, totaling 737,500 warrants. The sales were executed at an average price of $1.625, and were covered by purchases executed at $1 per warrant. Under the circumstances, Respondent 3's purchase and sale of 12.7% of the total number of warrants issued and outstanding[13] satisfy the magnitude requirement of Rule 10b-6.

Respondent 3 sales representatives received a sales credit averaging 29.17% of the total amount paid by the customer for the warrants, an amount even greater than the amount they received for their efforts in the Sound Source distribution. Accordingly, the Hearing Panel finds it to be presumptively excessive and outside of what could be considered as normal for ordinary trading transactions. No evidence was introduced upon which the Hearing Panel could find that the sales credit was not excessive under the circumstances.

Based on the magnitude of the offering and Respondent 3's special selling efforts, the Hearing Panel concludes that Respondent 3's purchase and sale of Sound Source warrants constituted a distribution.

II. Respondent 1 Did Not Violate Conduct Rule 2110

Causes two and six of the Complaint constitute the only charges against Respondent 1. They allege that, as the "head" trader, he knew or should have known that Respondent 3 was engaged in a secondary distribution of Sound Source and Chicago Pizza warrants, and that he

[13] There were 12,084,584 warrants issued and outstanding (1,800,000 IPO warrants + 270,000 over-allotment warrants + 10,014,584 selling security holder warrants). Respondent 3 purchased and resold 1,537,500 of those warrants.

directly participated in and facilitated the violations by Respondent 3 and Respondent 4 of Section 10(b) of the Exchange Act and Rule 10b-6 thereunder and NASD Conduct Rule 2110. As noted above, the Hearing Panel granted Respondent 1's motion for partial judgment at the close of Enforcement's case. The Hearing Panel finds that Enforcement did not prove that Respondent 1 knew or should have known that Respondent 3 was engaged in a secondary distribution of Sound Source and Chicago Pizza warrants, or that he knowingly participated in and facilitated violations by Respondent 3 and Respondent 4 of Section 10(b) of the Exchange Act and Rule 10b-6 thereunder and NASD Conduct Rule 2110. Accordingly, the charges against him will be dismissed in their entirety.

Without exception, each witness in this case verified that Respondent 4 dominated and controlled Respondent 3. The head of Syndicate testified that, "Respondent 4 was the main action in the transaction as he was in everything. You know, he was responsible for allocating and distributing what I call the retail side of the deal." Tr. 337. He was the one who determined when an IPO was "all sold." Tr. 345-46. He traded all new issues – "went in and started trading, sat right next to [Respondent 1] and traded." Tr. 350. Respondent 4 told the head of Corporate Finance when the Sound Source and Chicago Pizza IPOs were "all sold" on the retail side, and the head of Corporate Finance then notified NASD of that fact. Tr. 703-05.

The head of Trading testified that Respondent 4 was "totally" involved in trading. On the day an IPO became effective:

> . . . we would actually bring a chair and ashtray into the trading room for Respondent 4 . . . because he was involved on a trade-by-trade basis. As the calls were coming in, it was his decision whether to buy or just buy a minimal amount or to complete the order as it were, and so then once the activities ended, he would go back to his office and then we would communicate by phone. . . Any time that there . . .was activity in the stock if this was above and beyond ongoing instructions as to position, size, and/or quote, he would have to be consulted by Respondent 1.

Tr. 444-45. Respondent 1's job was to place orders to buy or accept orders to buy, or accept orders to sell, consistent with the instructions he had from Respondent 4. Respondent 4 controlled all activity in the trading room. KJ, who supervised Respondent 1, was the head of Trading,[14] but he did not review prospectuses, he was not told about any Selling Security Holder stock or warrants, and, because "Respondent 4 made all the decisions on whether to be long or short or to sell or buy," he did not need to know how the firm would cover a short position. Tr. 469. It was not unusual for Respondent 4 to take long or short positions with respect to issues in which Respondent 3 was a market maker. It was not unusual for Respondent 4 to build-in a sales credit for the registered representatives.

Respondent 1 was not in a position to know more about the issues he was trading than did his supervisor (who has not been charged with any violation), nor did he have any reason to know of the existence of Selling Security Holder warrants or of the trading strategy that Respondent 4 had in mind to cover a short position. On the day the IPOs became effective, the trading room was a scene of chaos and pandemonium, with hundreds of orders being filled. Respondent 1 was nothing more than a functionary, a low-level employee who was taking that information from Respondent 4 and inputting it into the NASDAQ system, within seconds after receiving it. There was no point in aftermarket trading at which Respondent 1 should have realized that a secondary distribution was occurring.

In similar circumstances, where a trader had no control over the underwriting and had an "exclusively ministerial role in the stock's aftermarket trading," all charges against the trader were dismissed, although principals of the firm were barred and fined for improper trading in the aftermarket following an IPO. *Brooks, Weinger, Robbins & Leeds, Inc.*, No. NY-7010, 1990 NASD Discip. LEXIS 143, at *58 (1990). *See also, K.A. JK& Co., Inc.*, Nos. CHI-903, 907 Amended, 933, 934, 955, 1988 NASD Discip. LEXIS 27 (1988) (charges dismissed against trader who had no involvement in pricing, although principals fined, censured, suspended, barred or expelled for, inter alia, violation of Rule 10b-6). The cases cited by Enforcement, holding traders liable for unlawful trading or aiding and abetting unlawful trading, are all inapposite because those traders had an interest in the issue or a direct involvement in pricing. *DBCC v. Richard R. Perkins*, No. C3A010043, 1992 NASD Discip. LEXIS 112 (March 2, 1992) (trader owned 30% of the firm , shared trading profits, determined mark-ups, and acted with scienter); *Michael A. Niebuhr*, Exchange Act Rel. No. 36620, 1995 SEC LEXIS 3451 (December 21, 1995) (trader also acted as registered representative selling stock to customers, and had self-interest in distribution since he was given 60,000 shares of stock); *Jeffrey D. Field*, Exchange Act Rel. No. 33952, 1994 SEC LEXIS 1169 (April 21, 1994) (Respondent was manager of trading and responsible for calculating mark-ups); *SEC v. Resch-Cassin & Co., Inc.*, 362 F. Supp. 964 (S.D.N.Y. 1973) (trader had profit motive in ownership of stock and commissions as a member of the selling group).

At the conclusion of the hearing, counsel for Respondent 1 moved for reimbursement of attorney's fees in the amount of $45,000, arguing that any fair investigation could have only led to the conclusion that Respondent 1 should not have been charged with any violation. At the conclusion of Enforcement's case, the Hearing Panel dismissed the charge that Respondent 1 did not knowingly violate any anti-fraud statute or rule. After considering all the evidence, the

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[14] Respondent 1 was not the "head trader," as alleged in the Complaint. At some point, he was appointed "trading manager," a title only. He never had decision-making or supervisory authority. KJ, not Respondent 1, initialed order tickets as "Manager."

Hearing Panel found that there was no reason for him to know that the firm and Respondent 4 were involved in any such violations. Accordingly, the Hearing Panel finds the argument for attorneys fees attractive. However, the Hearing Panel is constrained to deny the motion for lack of any authority to grant it.

Findings of Fact Regarding Supervision

The Compliance Manual and Activities

Respondent 2, Respondent 3's Vice Chairman, had responsibility for the non-revenue producing aspects of the firm. Tr. 914. From March to December 1995, he performed the functions of the Director of Compliance. Tr. 801. He authored the firm's written supervisory procedures. Tr. 787. Respondent 3 maintained a two-part compliance manual, consisting of a Registered Representative Policy Manual and a Supervisory Procedures Manual. CX 75. The compliance manual was continually modified by written supplements, dated and numbered in the same manner as are NASD Notices to Members. Tr. 826. At some unspecified point in time, an index to the supplemental memoranda was developed.[15] Tr. 929-32. The compliance manual was issued to every employee of Respondent 3, and each employee attested in writing to its receipt. Tr. 824-25.

Respondent 3 had a continuing education program that provided for periodic as well as annual compliance meetings that covered a variety of topics. RHX 13, 14, 15, 15A; Tr. 818-20. In addition, Respondent 3 held a separate annual compliance meeting for the trading department. RHX 13, at 2. The firm also compiled a Continuing Education Program Summary Report that detailed the name, title, date, and type of training each person in the firm received. RHX 9, at 5-26; Tr. 837-38.

Respondent 3 maintained and updated a Supervisory Personnel Schedule that specified all major departments and functions in the firm, as well as identified the persons who supervised them. RHX 16, at 3, 5, 8, 10, 14, 17, 20, 23; Tr. 862-64. That schedule, as amended in March 1996,shows Respondent 4 as Chairman and supervisor of Sales; AS, as Managing Director and supervisor of Underwriting and Syndicate; KJ, as Senior Vice President and supervisor of Trading and Market Making; and JK, as Director of Compliance and supervisor of Compliance. RHX 16, at 10. In January 1997, the schedule was updated to show that RR, a Managing Director, had succeeded AS as supervisor of Syndicate, and that EH was hired as General Counsel. RHX 16, at 14.

The Consolidated Trading Department Policies and Procedures Manual was created as a supplement to the Compliance Manual. CX 76. It provides that "[t]he SVP, Trading is specifically charged with overall supervisory responsibility for ensuring that all NASD Rules and firm policies and procedures governing the firm's participation as a NASDAQ market maker are followed by all Trading Department personnel. The SVP, Trading shall immediately report any infraction of any of these rules, policies or procedures by any employee of the firm to the Compliance Department." *Id.*, at 65-66. The Manual also contained policies and procedures relating to markups, markdowns, and price improvement on block trades. Id., at 45-46, 48. An internal system was developed and utilized to monitor domination and control on every small-cap stock in which Respondent 3 made a market. RHX 37; Tr. 865-66.

In the area of Corporate Financing and Syndicate, Respondent 2 met with the New York sales assistants to discuss procedures for sending out red herring prospectuses. RHX 11, at 3; Tr. 869. The director of retail sales held a meeting of brokers to discuss, among other items, the

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[15] The compliance manual that Enforcement received from Respondent 3 and introduced into evidence is incomplete.

proper way to take indications of interest. RHX 11, at 4; Tr. 870. Respondent 3's written supervisory procedures provided that, initially, Respondent 4 as Chairman was responsible for underwriting and syndicate activities. Later, AS was responsible for those activities. RHX 10, at 5; Tr. 871. The procedures also provided that Syndicate is "[r]esponsible for advising the Compliance Department of the participation of the firm in a distribution requiring the imposition of the *cooling off* period requirements of SEC Rule 10b-6." (emphasis in the original). RHX 10, at 1; Tr. 877-78. The Compliance Manual also has a number of references to "distributions" and securities on restricted and watch lists. RHX 10, at 2, 4, 9, 11, 19, 20; Tr. 878-82. When RR joined Respondent 3 in 1996, he, Respondent 2, JK, and CS (another employee in Compliance) began to write separate policies and procedures for Syndicate and Corporate Financing activities. The procedures were not completed while he was at Respondent 3, but the draft covered, among other items, allocation procedures, distributions, collection of free-riding and withholding questionnaires, and "all the things that are done for . . . preparing a transaction." Tr. 347.

In the section of the Compliance Manual that refers to trading and market-making, the Manual states:

> The Senior Vice President, Trading is responsible for all trading and market-making activities.
>
> The Trading Department is authorized to make a market in certain NASDAQ and NMS Securities. The firm may make a market in additional securities or temporarily or permanently cease market making in a security based on market conditions or the interest of the firm in the respective issuers or in order to comply with trading restrictions in connection with a distribution. Before a market is made in any security, approvals from the SVP, Trading and the Compliance Department must be obtained.

RHX 10, at 4.

Tr. 929.

Appointment of JK[16] as Director of Compliance

In January 1996, JK was hired to be the Director of Compliance at Respondent 3. Tr. 801. She held that position until March 1997. Tr. 802. She had been practicing law for seven years prior to her employment by Respondent 3. While at Respondent 3 she obtained Series 7, 63, and 24 licenses. Tr. 801, 921. She was located in New York City, as was her successor, CS. JK expanded the Compliance Department and hired CS, who had 10 or 11 years of compliance experience. He remained with the firm only two or three months after JK left. He was succeeded by BM who had 18 to 20 years of securities industry experience, almost all in compliance, and who was located in Los Angeles. Tr. 802-03.

Prior to JK's hiring, Respondent 2 prepared a written position description for the Director of Compliance. Tr. 860. It states that the mission of the Compliance Department is to "[e]stablish and maintain a supervisory and compliance *system* . . . that is reasonably designed to insure compliance with applicable . . . laws, rules, regulations and policies to which the firm and its associated persons are subject." RHX 4. In pertinent part, it lists as the Director's primary functions:

- Responsibility to maintain and update the *SUPERVISORY PROCEDURES MANUAL* and *REGISTERED REPRESENTATIVE POLICY MANUAL*; prepare and maintain Supplements to each manual, as necessary and appropriate.

[16] Although JK provided an on-the-record interview to NASD staff on June 17, 1998, she declined to testify in this proceeding. A redacted version of her interview transcript is CX 108. Respondent 2 takes the position that he delegated all compliance functions to her. Enforcement counters that she was inexperienced, and that Respondent 2 was really in charge of compliance. Although JK was not named as a respondent in this proceeding, it is not likely that, at the time of her interview, she would testify against her own interests and risk being named as a respondent. Because the Hearing Panel did not have the opportunity to observe her demeanor or assess her testimony in light of cross-examination, it cannot credit those portions of her interview that were offered to counter live testimony that the Hearing Panel does credit. Her refusal to testify, even by telephone, constrains the Hearing Panel to give little weight to her assertions in the recorded interview. *See Vincent J. Puma*, No. C10000122, (NAC October 21, 2002) (Remand Order) (factors used to assess reliability of hearsay evidence).

- Responsibility to establish and maintain internal controls to review and monitor in a proper manner such activity including, but not limited to . . .

  * * *

  Trading and Market Making activity.

Id. The position requirements included the Series 7, 63, and 24 licenses, as well as a working knowledge of NASD and SEC rules, including "10B-6 . . . IPO'S, PRIVATE PLACEMENTS, SECONDARY OFFERINGS; [and] MARKET MAKING . . . ." *Id.*

Respondent 2 knew that, at the outset, JK needed his help in performing her job. Tr. 923-24. However, within a few weeks, she was acting on her own initiative. On February 20, 1996, she wrote to Respondent 4, requesting that he fill out the Annual OSJ Compliance Inspection Form and have it ready for her when she arrived in Los Angeles three weeks later to begin the "in person" phase of the OSJ Inspection. RHX 7, at 6; Tr. 846-47. She quickly became involved in Corporate Finance and Syndicate matters at Respondent 3. On February 22, 1996, she wrote to the administrative assistant to the Corporate Finance Director, requesting a weekly report of all prospective syndicate groups and selling groups in which Respondent 3 would like to participate, and copies of all Corporate Finance Department Status Reports. RHX 16A, at 1; Tr. 857. On that same day she wrote to the same administrative assistant requesting advance warning of every syndicate and selling group in which Respondent 3 planned to participate. *Id*., at 2. On March 6, 1996, she sent Corporate Finance a form that she had prepared for it to return to Compliance every week in order "to make communication between Compliance and Corporate Finance more efficient." *Id*., at 3. Corporate Finance/Syndicate Interoffice Procedures required that registration statements, upon filing, should be forwarded to the clearing firm and to JK, and that on pricing day, syndicate/selling group breakdowns should be sent to JK, among others. *Id*., at 7; Tr. 859. JK also wrote the Free Riding and Withholding supplement to the Compliance Manual and, at an October 10, 1996, annual compliance meeting, discussed that topic and IPOs with the account executives in attendance. RHX 10, at 23; 11, at 1-2.

Discussion of Supervision Allegations

Cause Nine of the Complaint alleges that, at all times relevant to the Complaint,[17] Respondent 3, through Respondent 2, failed to establish and maintain an adequate supervisory system; failed to establish, implement, and enforce written supervisory procedures; and failed to exercise adequately or reasonably its supervisory responsibilities. The Hearing Panel concludes that Respondent 3's supervisory system and procedures were reasonably designed to achieve compliance with applicable securities laws and regulations and NASD Rules. The Hearing Panel also concludes that Respondent 2 was not shown to have failed adequately or reasonably to exercise his supervisory responsibilities, in violation of Conduct Rules 2110 and 3010.

NASD Conduct Rule 3010 provides that each member shall establish and maintain a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]," and that such supervisory system shall include written procedures "reasonably designed to achieve" that same compliance. Senior managers are not held strictly liable for violations of the securities laws and regulations committed by their subordinates. Rather, the question is whether senior managers have reasonably discharged their supervisory duties under the attendant circumstances. *See Arthur James Huff*, Exchange Act Rel. No. 29017, 1991 SEC LEXIS 551, at *10-11 (March 28, 1991); *Louis R. Trujillo*, Exchange Act Rel. No. 26635, 1989 SEC LEXIS 480, at *10 (March 16, 1989).

Respondent 3 maintained and updated a Supervisory Personnel Schedule designating a supervisor for each area of the firm's business. At the time relevant to the Complaint, Respondent 4 was designated as the supervisor of Sales, AS was the supervisor of Underwriting and Syndicate, KJ was the supervisor of Trading and Market Making, and JK was the supervisor of Compliance. Respondent 2 was not shown as a supervisor on that Schedule. Rather, he was responsible for the non-revenue producing aspects of the firm. However, only Respondent 2, and none of the other supervisors, is charged with failing to exercise reasonable and adequate supervision, and, in essence, failing to prevent violations of SEC Rule 10b-6 with respect to the Sound Source and Chicago Pizza offerings.

Respondent 3's Compliance Manual, which was written by Respondent 2,[18] provided that the Senior Vice President, Trading (KJ), had overall responsibility for market making activities. The Manual required the approval of the Senior Vice President, Trading, and the Compliance Department before a market could be made in any security. Syndicate (AS) was responsible for notifying Compliance (Knapp) of any distribution requiring a cooling off period under Rule 10b-6. Moreover, although it had not been completed at the time of the Sound Source and Chicago Pizza offerings, a separate policies and procedures manual for syndicate and corporate finance activities was in draft form and covered such items as allocation procedures, distributions, and free-riding and withholding. JK helped to draft those separate policies and procedures.

In early 1996, JK had requested information on all prospective syndicate groups and selling groups, copies of all Corporate Finance Department Status Reports, and copies of all registration statements. According to the Compliance Manual and the practices implemented by

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[17] The relevant time period is 1996, and the Complaint specifically refers to the Sound Source and Chicago Pizza offerings.

[18] In his testimony, Respondent 2 noted that the SEC and NASD reviewed the written supervisory procedures and found them to be adequate. However, the responsibility for compliance with applicable regulatory requirements,

JK, the Compliance department should have had adequate information from Corporate Finance and Syndicate on any issue in which Respondent 3 intended to be a market maker, upon which it could consult with Trading and approve Respondent 3's participation as a market maker. Registration statements were included in the information that was to be sent to Compliance. The registration statements for Sound Source and Chicago Pizza both indicated that Selling Security Holders would be selling a significant amount of, if not all, stock and warrants through Respondent 3 as underwriter. The Compliance Manual provided that Syndicate was to notify Compliance of a distribution requiring a cooling off period pursuant to Rule 10b-6. There was no specific mention of notice of a distribution that did not require a cooling off period, but JK put into place a process by which Compliance was to receive all registration statements. The registration statements for Sound Source and Chicago Pizza were sufficient to put Compliance on notice that a distribution was a reasonable possibility. AS, as supervisor of Underwriting and Syndicate, must have known what was contained in those registration statements. JK should have known from those registration statements that Selling Security Holders were bound to sell their interests through Respondent 3, and there is no evidence that, in her daily contacts with Respondent 2, she ever raised any question about the Sound Source or Chicago Pizza offerings.

A complete review of the Compliance Manual cannot be made because the copy that Enforcement received from Respondent 3 was incomplete. Tr. 929. However, the Hearing Panel has considered those parts of the Manual that were put in evidence, as well as the testimony and other documents that relate to continuing education, annual and periodic compliance meetings, and required submissions to Compliance of registration statements and other syndicate and finance reports. Based on that evidence, the Hearing Panel concludes that Enforcement has not

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including the adequacy of a compliance manual, cannot be shifted to regulatory authorities. *See James L. Owsely*, met its burden to show that the written supervisory procedures were inadequate and not reasonably designed to achieve compliance with applicable securities laws and regulations and with NASD Rules.

Respondent 2 ended his compliance duties when he hired JK to be the Director of Compliance. However, as the SEC has noted, "it is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention . . . . Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised." *Rita H. Malm*, Exchange Act Rel. No. 35000, 1994 SEC LEXIS 3679, at *23 (Nov. 23, 1994) (citation omitted). The burden on Enforcement, though, is to demonstrate on the facts of the case that Respondent 2' conduct was not reasonable. "It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better." *DBCC v. Lobb*, No. C07960105, 2000 NASD Discip. LEXIS 11, at *16 (NAC April 6, 2000). Here, Enforcement has not met that burden.

Enforcement argues that JK's location in New York, her inexperience, and Respondent 2's "insufficient assistance" prevented JK from adequately performing her compliance function regarding the firm's underwriting and distribution activities. However, in view of her on-the-record testimony that she reported daily to Respondent 2,[19] and that he helped her in "all areas,"[20] the Hearing Panel has no basis to conclude that Respondent 2 gave her insufficient assistance. Nor can the Hearing Panel conclude, in view of the findings of fact that she was actively engaged

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Exchange Act Rel. No. 32491, 1993 SEC LEXIS 1525, at *25 (June 18, 1993).

[19] CX 108, at 9, 15.

[20] *Id*, at 23.

in compliance functions from the inception of her appointment as Director of Compliance, that she was unable to function adequately in that position, or that her location in New York prevented effective oversight in Los Angeles. As early as February 1996, she sent out OSJ Compliance Inspection Forms to the Los Angeles office in contemplation of her imminent "in person" inspection. Finally, the Hearing Panel cannot conclude, in the face of her written demand for registration statements and other Syndicate and Corporate Finance reports, that she was unaware of IPO and Selling Security Holder offers in which Respondent 3 was acting as underwriter and market maker.[21]

On the second day of aftermarket trading in Chicago Pizza, JK discussed IPOs at an annual compliance meeting. Even if JK failed adequately to perform her functions as Director of Compliance, any such failure, and any securities law violation that may have occurred as a result of such failure, does not mean, *ipso facto*, that Respondent 2 did not reasonably supervise JK. There were no red flags to indicate to Respondent 2 that JK was not performing adequately. She spoke to him daily, and testified that if she "had any problems" she went to Respondent 2 who helped her "in all areas."[22] CX 108, at 23.

[21] Enforcement introduced only a redacted version of JK's on-the-record interview. In that redacted testimony, she was not asked about her responsibilities, as set out in the Compliance Manual, to approve market making in conjunction with Trading, or to be given notice by Syndicate of any distribution. In her testimony, she claimed that she had no duties that would bring her into contact with Trading. CX 108, at 10. She also claimed that she had no involvement with IPOs except for free riding and withholding. *Id*., at 11, 19. Moreover, she was not asked why, if she had asked for registration statements, she had never seen, as she claimed, the alternate prospectus for Chicago Pizza or that she was unfamiliar with the term "selling security holder." The redacted testimony presents JK as an ingénue. Without the opportunity to observe her demeanor as a witness, the Hearing Panel cannot credit her on-the-record testimony in light of the inconsistencies between that testimony and the live testimony and exhibits which the Hearing Panel finds to be credible and upon which the Hearing Panel has made its findings of fact.

[22] This testimony of JK is consistent with Respondent 2' testimony that he worked closely with JK, that he instructed her to bring any problems to his immediate attention, and that he was available by phone at any hour of the day. Tr. 851, 886, 925.

Facts regarding Cancellation of Scoop, Inc. Stock Purchases

Scoop, Inc. was a development stage company that delivers business information services to its customers through the Internet, using an extensive array of well-recognized news and information sources. CX 78, at 2-4. It raised capital in 1996 by completing various rounds of private funding, including a private placement offering that began in April 1996 and ended in July 1996. Respondent 3 was the selling agent and raised a total of $2.5 million by selling the private placement to its customers. *Id*, at 22; Tr. 143.

Scoop initially retained Respondent 3 to manage its IPO. Respondent 3 hired the law firm of J, M, B & M, LLP ("J, M") as underwriter's counsel, and, together, they filed the first registration statement with the SEC on October 30, 1996. CX 79. On February 27, 1997, J, M filed an amended registration statement with the SEC, because Respondent 3 had been replaced by SG as the managing underwriter, and SG retained J, M to continue as underwriter's counsel. CX 82. The Scoop offering was the first in which SG participated in an underwriting capacity. CX 78.

The Scoop IPO provided for the issuance and sale of 1,450,000 shares of common stock at a public offering price of $4.50 per share, with an over-allotment option for the underwriter to purchase an additional 217,500 shares. CX 78, at 1. The registration statement also included an alternate prospectus and covered a concurrent registration of 1,199,481 shares of common stock owned by certain Selling Security Holders, pursuant to SEC Rule 415, and 200,000 consultant warrants. CX 77, at 1[23]. The alternate prospectus provided that the Selling Security Holders' shares were subject to lock-up agreements and could be released for sale to the public only by

[23] The Prospectus noted that, including the exercise of the Consultant Warrants, 2,849,481 shares of stock would become freely tradable upon the termination of any lock-up. CX 77, at 16.

SG. *Id*., at 15. The Selling Security Holders were those Respondent 3 customers who had invested in the 1996 private placement. Tr. 144-45.

Between March 5, 1997, and April 9, 1997, J, M corresponded with NASD's Corporate Financing Department regarding the terms of the Scoop IPO. CX 83-84, 86-93. J, M sought terms under which NASD Corporate Financing would allow SG to release Selling Security Holders from lock-up agreements without obtaining formal pre-approval from NASD. CX 91. As a result, the final alternate prospectus provided that, if any NASD member acquired, from a Selling Security Holder, Scoop stock released from lock-up, the member would notify NASD's Corporate Financing of the lock-up release and indicate that the member was in compliance with certain conditions required by NASD. CX 77, at 55; CX 92. The alternate prospectus also provided for the filing of a post-effective amendment to the prospectus as follows:

> If any Selling Security Holder sells his, her or its Selling Security Holders' Shares pursuant to this Prospectus at a fixed price or at a negotiated price which is, in either case, other than the prevailing market price or in a block transaction to a purchaser who resells, or if any Selling Security Holder pays compensation to a broker-dealer that is other than the usual and customary discounts, concessions or commissions, or if there are any arrangements either individually or in the aggregate that would constitute a distribution of the Selling Security Holders' Shares, a post-effective amendment to the Registration Statement of which this Prospectus is a part would need to be filed and declared effective by the Securities and Exchange Commission before such Selling Security Holder could make such sale, pay such compensation or make such a distribution.

Id. Respondent 2 was sent a copy of the letter from J, M to NASD Corporate Financing. CX 92.

The Scoop IPO became effective on April 9, 1997. Respondent 3 did not participate in the IPO in any underwriting capacity. Tr. 143. Twenty-four broker-dealers, including Respondent 3, appeared as market makers in the stock. CX 101.

Following the aftermarket opening in Scoop common stock, SG agreed to release for sale the Scoop common stock held by the Selling Security Holders. JS, Chairman of SG, confirmed the release in a letter to Respondent 4, dated April 9, 1997, in which he stated that Respondent 3 was authorized to act as the purchasing broker-dealer for the transaction, subject to its compliance with the procedures imposed by NASD at the time of the Scoop offering. CX 94; Tr. 153. On that same day, Respondent 3 sent to NASD Corporate Financing two Selling Security Holder Lock-Up Release Notification Forms completed by Respondent 4. CX 95. On those Forms, Respondent 3 disclosed that at 2:09 p.m. on April 9, 1997, it purchased a total of 1,072,497 shares of Scoop stock on a principal basis from Selling Security Holders, all at $4.28 per share. The Forms reported that, at the same time, 700,000 shares were sold to SG at $4.28 per share, and the remainder to Respondent 3 clients at $4.50 per share. *Id*. Neither SG nor Respondent 3 filed a post-effective amendment with the SEC in regard to the Selling Security Holders' shares. Tr. 154.

At some time on Wednesday, April 9, or Thursday, April 10, 1997, Respondent 4 informed Respondent 2 that Sheehan had called to tell him that SG was going to rescind the lock-up release. Tr. 893. SG demanded that Respondent 3 repurchase the 700,000 shares it sold to SG and cancel back the purchases from the Selling Security Holders. SG also cut back the number of Selling Security Holder shares that Respondent 3 could sell. CX 97; RHX 27. As a result, numerous meetings took place over the next few days among Respondent 3 executives, Respondent 3 counsel, and SG' counsel. Tr. 694-95, 893. None of the individuals participating had ever before encountered such a situation. RHX 27; Tr. 716-17, 894.

On Friday, April 11, 1997, SG verbally reiterated that the release of the lock-up had been rescinded as to the shares it purchased from Respondent 3, but advised that 500,000 shares were released. CX 98; RHX 32. On Monday, April 14, 1997, J, M wrote to Respondent 3 that "any lock-up releases granted on the effective date were validly rescinded due to concerns over the circumstances surrounding such releases," and that only 135,000 shares had been validly released from lock-up. RHX 21. On April 17, 1997, Respondent 2 notified NASD Corporate Financing that Respondent 3 had cancelled a number of shares at some time after receipt of the April 11 notice from SG, and that it cancelled more shares after the April 14 notice from SG. RHX 32; Tr. 907-08.

Respondent 2 proposed to Respondent 4 that the cancellation of the trades be done on a pro rata basis, with each investor's transactions reduced by an equal percentage. RHX 35; Tr. 996. EH concurred with the idea to effect some kind of pro rata cancellation. Tr. 1019. However, Respondent 4 made the decision to cancel the trades outright. After his conversation with JS, Respondent 4 called PO to his office and said to him, "The Scoop trades - bust them all." Tr. 736. PO told Respondent 2 about the conversation, and then complied with Respondent 4's directive. Tr. 736, 896-97. Respondent 2 did not have the authority to cancel the trades on his own. Tr. 696, 738, 898.

Respondent 3 eventually cancelled customer purchases totaling 439,800 shares of Scoop stock. CX 104. During the time the customer trades were being cancelled, Scoop shares remained available in the aftermarket, and initially increased in price. RHX 31; Tr. 158.

As a result of the rescission of the lock-up, Respondent 3 commenced an arbitration before NASD in which it sought damages and an injunction ordering SG to release the remainder of the Selling Security Holders' shares. Respondent 3 did not obtain the injunction, but it received an award in the amount of $350,000. RHX 27, at 2.

Discussion of the Cancellation of Customer Purchases of Scoop, Inc.

When a firm accepts orders from customers, it has a duty to execute them, or obtain the customers' consent to change the orders. Although there is a dearth of case law addressing the cancellation of customers' trades, the SEC addressed a market maker's duty to its customers in unusual circumstances as follow:

> Where an unusual market situation exists, and the immediate execution of market orders would result in significant disruption in the market and, consequently, in executions that would vary significantly from customer expectations at the time the orders were entered, it may well be preferable for a firm to contact its customers promptly, inform them of the change in market conditions, and obtain further instructions from those customers with respect to the execution of their orders. *But a firm cannot substitute its own judgment for its customers' informed consent to changes in their orders' terms or manner of execution. In the absence of such consent, a firm has a duty to execute customer orders fully and promptly*. (emphasis added).

Bateman Eichler, Hill Richards, Inc., Exchange Act Rel. No. 20797, 1984 SEC LEXIS 1908, at *8-9 (March 29, 1984), *aff'd sub nom. Eichler v. SEC*, 757 F.2d 1066 (9th Cir. 1985). Here, the customers' trades were executed and reported after the release of the lock-up. When the release of the lock-up was rescinded, Scoop shares remained available in the aftermarket. However, Respondent 3 unilaterally decided to cancel customers' trades, rather than contacting those customers for permission to cancel the trades or instructions to obtain shares from the market and make the trades good. Given the facts that the price of the stock was rising after the lock-up was rescinded, and that no one involved had ever experienced such a situation, Respondent 3 faced a difficult decision on how to proceed, one that had the potential for severe financial loss. However, its duty to its customers mandated that those customers be consulted before any trade was cancelled.

Respondent 2, however, cannot be held liable for the unilateral cancellation of customers' trades. The facts clearly demonstrate that the decision to cancel the trades rested entirely with Respondent 4. It was he who dominated and controlled the firm and, after discussing the matter with a number of Respondent 3 executives and counsel, told PO to "bust the trades." Every witness who testified about the cancellation of trades stated that Respondent 4 made the decision. Even Respondent 4, in his on-the-record interview, could not say, or would not say, with any certainty who was responsible for that decision:

> Q. So who was the person who made the decision that you were going to handle it by canceling the orders?
>
> A. I really don't remember. I really don't. I really don't. I don't know if it was Respondent 2, if it was Respondent 2 and I.

CX 105 (Respondent 4 Transcript), at 64. Respondent 4 conferred with a number of persons before making the decision to cancel the trades, but no one who gave him advice can be held responsible for the ultimate decision to cancel them. Moreover, there is no evidence that Respondent 2, or anyone other than Respondent 4, had the authority to cancel the trades. Accordingly, the Hearing Panel concludes that Respondent 2 cannot be held liable for canceling the Scoop, Inc. trades, as alleged in the Complaint.

Conclusions

The Hearing Panel concludes that Respondent 1 has not been shown to have participated in or facilitated the violations of Respondent 3 and Respondent 4 of Section 10(b) of the Exchange Act and Rule 10b-6 thereunder, and NASD Conduct Rule 2110, as alleged in Causes Two and Six of the Complaint, and that the Complaint against him should be *dismissed*.

The Hearing Panel concludes (1) that Respondent 2 has not been shown to have failed to establish, implement, or enforce written supervisory controls or procedures, in violation of NASD Conduct Rules 2110 and 3010, as alleged in Cause Nine of the Complaint; (2) that he has not been shown to have been responsible for the unilateral cancellation of retail customers' purchases of Scoop, Inc. shares, in violation of NASD Conduct Rule 2110, as alleged in Cause Ten of the Complaint, and (3) that the Complaint against him should be *dismissed*.

SO ORDERED.

Alan W. Heifetz
Hearing Officer
For the Hearing Panel