

This Decision has been published by the NASDR Office of Hearing Officers and should be cited as OHO Redacted Decision C3A990067.

NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondents.

Disciplinary Proceeding
No. C3A990067

Hearing Officer—Andrew H. Perkins

Hearing Panel Decision as to Respondent

November 15, 2000

Digest

The Department of Enforcement filed a Complaint alleging that Respondent _____ failed to supervise Respondent _____, in violation of NASD Conduct Rules 2110 and 3010. Based on the evidence admitted at the hearing, the Hearing Panel determined that _____ was not charged with _____ supervision in corporate finance and that he had not failed to exercise

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reasonable supervision of her retail brokerage activities. Accordingly, the Hearing Panel dismissed the Complaint against _____.

Appearances

Jacqueline D. Whelan, Regional Counsel, Denver, Colorado, and Rory C. Flynn, Chief Litigation Counsel, Washington, DC, counsel for the Department of Enforcement.

_____ and _____, _____, _____, _____, _____ & _____, Houston, Texas, for Respondent _____.

DECISION

I. Introduction

This disciplinary proceeding concerns certain improprieties in the manner in which the Houston Branch Office of _____, Inc. (“_____” or the “Firm”), an NASD member broker-dealer, conducted its corporate finance activities between early 1994 and 1996. In connection with a routine examination of _____ that started in December 1995, NASD Regulation, Inc. (“NASD Regulation”) examiners noticed some unusual entries on a sample of the Firm’s books and records from the Houston Branch Office.¹ As a result, NASD Regulation Staff conducted an on-site examination of the Houston office in April 1996. That examination focused on certain activities of Respondent _____ (“_____”) and the Firm’s corresponding records that disclosed that she had received money into her account at _____ from an affiliate of one of the Firm’s investment banking clients. Ultimately, NASD Regulation

¹ _____ kept most of its books and records in its Offices of Supervisory Jurisdiction. The Houston Branch Office was one of those offices. (Tr. 39.)

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Staff opened a spin-off examination that focused on _____'s activities in connection with a 1994 agreement by which Nevada Gold and Casinos, Inc. ("Nevada Gold") purchased some real estate from Winstock Mining Corporation ("Winstock") (the transaction is described below as the "Winstock Option Transaction"). Under their agreement, Nevada Gold was to pay for the real estate with approximately five million shares of Nevada Gold stock. NASD Regulation Staff concluded from its examination that _____ committed a number of NASD Rule violations in connection with her involvement in the Winstock Option Transaction,² which led to the filing of the instant Complaint.

A. The Complaint

The Complaint contains eight causes. The first six pertain only to _____. They charged that she: (1) failed to establish a proper account in connection with the Winstock Option Transaction, in violation of Securities and Exchange Commission ("SEC") Rule 15c2-4 and NASD Conduct Rule 2110; (2) disbursed investor funds to Nevada Gold prior to the satisfaction of the minimum sales contingency, in violation of SEC Rule 10b-9 and NASD Conduct Rule 2110; (3) failed to terminate the Winstock Option Transaction offering when the minimum sales contingency was not met, in violation of SEC Rule 10b-9 and NASD Conduct Rule 2110; (4) functioned as a broker-dealer without registration,³ in violation of Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") and NASD Conduct Rule 2110; (5) improperly used and mishandled customer funds, in violation

² While the Complaint also charged that _____ mishandled two private placements for Nevada Gold, Enforcement did not present evidence of these violations at the hearing. Instead, Enforcement limited its case to the alleged violations surrounding the Winstock Option Transaction.

³ _____ was, however, registered as a General Securities Representative with _____.

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of NASD Conduct Rules 2110 and 2330(a); and (6) participated in private securities transactions without providing prior written notice to the Firm, in violation of NASD Conduct Rules 2110 and 3040.

The seventh cause charged _____ (“_____”), _____’s General Counsel, and _____ (“_____” or the “Respondent”), the branch manager of the _____’s Houston Branch Office, with failure to reasonably supervise _____, in violation of NASD Conduct Rules 2110 and 3010.

The final cause charged _____ with failure to establish, maintain, and enforce written supervisory procedures reasonably designed to achieve compliance with applicable laws, rules, and regulations, in violation of NASD Conduct Rules 2110 and 3010. Both _____ and _____ entered into settlements that were approved by the National Adjudicatory Council. Therefore, this Decision pertains only to Respondent _____.

B. The Charge Against _____

With respect to the charge of deficient supervision against _____, the Department of Enforcement (“Enforcement”) alleged that _____ and _____, along with other unnamed persons at _____, shared responsibility for _____’s supervision. (Compl. ¶ 22.) Enforcement’s theory is that _____, although not directly responsible for supervision of _____’s corporate finance activities, was responsible for “those aspects of her oversight that could effectively be undertaken only by someone at the same location.” (Department of Enforcement’s Pre-Hearing Statement of the Case at 12.)

Enforcement contends that as the only registered principal realistically capable of responding to “red flags” arising at the points where _____’s corporate finance activities intersected with the retail and operations functions of the branch office, he could not ignore those “red flags” of which he was or

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should have been aware. (Id. at 13.) Specifically, Enforcement argued that _____—by reason of inadequate supervision—failed to detect and prevent _____ from committing the following violations: (1) participating in private securities transactions; (2) functioning as a broker-dealer without proper registration; and (3) mishandling investors’ funds. (Department of Enforcement’s Opposition to Motion for Summary Disposition by Respondent _____ at 4.)

In response to the Respondent’s motion for a more definite statement of the charges against him, Enforcement enumerated the following four “red flags” that it contends _____, as manager of the Houston Branch Office, should have noticed and reacted to:

- 1) _____ received from _____ options to purchase the common stock of Nevada Gold.
- 2) _____ employed two assistants in the corporate finance department although she had little or no retail business.
- 3) The blotters in the Houston Branch Office reflected numerous checks received in and sent out of _____’s account at the Firm.
- 4) Correspondence among _____ and others involved in the Winstock Option Transaction was received at and sent from the Houston Branch Office.

(Response to Motion for More Definite Statement at 2-3.)

Enforcement also contended that _____ was more involved in the corporate finance department than he claimed. As evidence of his active participation, Enforcement pointed to a series of memoranda he received from _____ in or about August 1994. The memoranda had been requested by _____ to inform him of the status of each of _____’s corporate finance projects. Based on the

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existence of these memoranda and the on-the-record interview testimony of _____ (“_____”), _____’s former President and Chief Operating Officer,⁴ Enforcement argued that for at least a portion of the period in question, _____ was in fact deeply immersed in the functioning of the corporate finance department and _____’s supervision.

On the other hand, _____ contended that he had no supervisory responsibility for _____ in connection with her corporate finance activities. _____ further contended that he observed the Chinese Wall between corporate finance and his retail operations. According to _____, he requested the memoranda from _____ only after _____ called and informed him that _____ had jeopardized the Firm by obligating it to do a firm commitment underwriting for which it did not have adequate capital and that this was _____’ problem. In other words, according to _____, he made the inquiry of _____ because he was being blamed by _____ for something about which he had no information.

The Hearing Panel found _____’ testimony credible and supported by the preponderance of the other evidence. Accordingly, for the reasons set forth below, the Hearing Panel found that Enforcement had not proved the charge against _____, and it therefore dismissed the Complaint.

II. Procedural History

Enforcement filed the Complaint in this proceeding on December 7, 1999. Each of the Respondents answered and requested a hearing. Prior to the hearing, _____ filed a motion for summary disposition pursuant to Code of Procedure Rule 9264 seeking dismissal of the charge against _____

⁴ _____ joined _____’s board of directors in December 1993 and became the President and Chief Operating Officer on January 10, 1994. He also was President and Chief Operating Officer of _____ Group, a holding company. (CE 63,

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him, which Enforcement opposed. On July 6, 2000, the Hearing Panel denied the motion for summary disposition on the ground that the factual record was not so clear as to enable the Hearing Panel to find that there were no genuine issues in dispute with regard to any material facts.

On July 18, 19, and 20, 2000, a Hearing was held in Houston before a Hearing Panel comprised of the Hearing Officer and one former and one current member of the District Committee for District 6. Enforcement offered the testimony of six witnesses, including the Respondent. Enforcement also offered 68 exhibits (CE 14-15, 19-62, 63A, 64; R 4; JE 1-19), which were admitted into evidence.⁵ _____ offered 38 exhibits (R 11, 18, 19, 37, 68-97, 100A, 102-04), which also were admitted into evidence.

At the conclusion of Enforcement's case-in-chief, _____ moved to dismiss the Complaint. After hearing argument from both Parties, the Hearing Panel granted the motion because Enforcement had failed to show by a preponderance of the evidence that _____ had supervisory responsibility for _____ and that he had failed to supervise her, as alleged in the Complaint.

at 4.) _____ is currently in the ministry. His registration with the NASD terminated on June 28, 1996.

⁵ Reference to the hearing transcripts are cited as "Tr. ____." Citations to exhibits are as follows: Enforcement's are noted as "Ex. CE ____"; Respondent's are noted as "R ____"; and the Parties' joint exhibits are noted as "JE ____." On November 14, 2000, the Hearing Officer ordered the Department of Enforcement to file a corrected version of Exhibit 63A, which is a copy of the transcripts of the on-the-record interviews of _____ taken on March 27 and September 15, 1997. Replacement Exhibit 63A was filed on November 15, 2000.

III. Findings of Fact

A. Background

1. The Respondents

a) _____

During the relevant period, _____ was a registered General Securities Principal and the branch manager of _____'s Houston Branch Office. (Tr. 488.) On or about April 1, 1994, _____ purchased the Houston Branch Office and continued to operate it as an Office of Supervisory Jurisdiction under the _____ name. (Tr. 497.) The Houston Branch Office was one of _____'s largest. It had approximately 40-45 brokers and a small corporate finance department run by _____.

_____ has been in the retail brokerage business for more than 30 years. (Tr. 373.) He started at Merrill Lynch, Pierce, Fenner & Smith, Inc., and, over the years, he worked at firms such as Shearson Lehman Brothers, Inc. and E. F. Hutton & Company, Inc. before joining _____ in 1991.

b) _____

_____ first worked in the securities business as a General Securities Representative with the broker-dealer subsidiary of First Interstate Bank of Texas. (CE 64, at 8.) Thereafter, she worked on corporate accounts at E.F. Hutton & Company, Inc. ("E.F. Hutton"), Shearson Lehman Brothers, Inc., and Oppenheimer & Co., Inc. before being recruited by _____ to join _____ in May 1993 as a broker. (Id. at 8-9.) _____ was registered with _____ as a General Securities Representative from approximately May 1993 until May 1998. (Tr. 115.) Like the other brokers at _____, _____ operated under an independent contractor agreement. (Tr. 177.) When _____ joined _____, she

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had no investment banking experience; therefore, at first, she operated strictly as a retail broker. (CE 64, at 9.) However, she had an interest in moving into corporate finance, and, when _____ joined _____ as its President and Chief Operating Officer in January 1994, she was given the opportunity to move into that department. (Tr. 179-80.). Shortly after she moved over to the corporate finance department as a consultant, _____ transferred her remaining retail accounts to himself under a new number. (Tr. 488-89; CE 64, at 10.) Thereafter, _____ was involved only with corporate finance.

c) _____

_____ joined _____ as Senior Vice President and General Counsel in April 1995. (Tr. 341.)

He had previously worked as a registered representative with E.F. Hutton before he attended law school. (Tr. 348.) In November 1995, _____ became registered as a General Securities Principal. (Id.) He is not currently employed in the securities industry. (Tr. 340.)

2. _____'s Corporate Finance Department and Business

To understand the alleged supervisory defaults surrounding the Winstock Option Transaction it first is necessary to explain the formation and operation of _____'s corporate finance department.

Prior to 1994, _____ had little or no corporate finance business. But _____ had expressed her interest in moving into that area. As a result, when _____ joined the Firm in January 1994 with plans to build and operate a corporate finance department, _____ (“_____”), then the President of the Firm, called _____ and told her that this was “kind of [her] perfect scenario.” (Tr. 179-80.) Shortly thereafter _____ and _____ got together and developed an arrangement for how they would work together in corporate finance. (Tr. 180.) _____ told _____ that if he was going to help her develop a

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corporate finance department, he would have to receive a higher percentage of everything she produced. (Tr. 184-85.) She also was obligated to pay _____ 10% of everything she produced to cover the costs of the office space and equipment her department used. (Tr. 183-84.)

Under _____'s direction and supervision, the corporate finance department was located in Houston although _____, _____'s new President and Chief Operating Officer, would be at the Firm's headquarters in Denver. (Tr. 447-48.) While the evidence is not clear as to the precise sequence of events, once she got the green light, _____ put together a staff and set up a separate company, _____, Inc. ("_____"), to conduct her corporate finance business. _____ explained that she set up _____ for tax reasons at _____'s suggestion because under her agreement with _____ she was responsible for the payment of all of the expenses associated with her corporate finance activities. (Tr. 154.) Consistent with the Firm's obligation to segregate its corporate finance business from its retail operations, separate office space was constructed at the Houston Branch Office to house her operation. (Tr. 203-04.) Only _____ and her staff had access to this locked area.⁶ (Tr. 204.) It was not possible to access her office area directly from _____'s retail brokerage office. (Id.)

In 1994, _____ and _____ had only a few corporate finance clients: Airworks Media, ZCL Composites, Inc. (also referred to in the exhibits as ZCL Mfg. Canada, Inc.) ("ZCL"), Electrocel Technology Systems, Schooner's International, and Nevada Gold. (Tr. 86; CE 54.) The most active was Nevada Gold. Apart from the Winstock Option Transaction discussed below, _____ worked on

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two joint ventures for Nevada Gold involving the construction of a casino on the property it acquired from Winstock in Black Hawk, Colorado. The first was with United Gaming Corporation, and the second was with Caesar's World Gaming. (Tr. 119, 137.) These investment banking and consulting services were provided to Nevada Gold under two letter agreements dated April 15, 1994, and October 1, 1995. (JE 4; JE 14.) In 1994, _____ also completed two private offerings and a debt financing for Nevada Gold. (Tr. 369.)

_____ managed all of _____'s corporate finance business out of the Houston Branch Office. There was a period in 1994, however, when _____ suspended _____'s corporate finance business due to a problem with a firm commitment underwriting for ZCL. (Tr. 514.) To complete the underwriting, _____ needed a co-underwriter, and _____ had approached Neidiger, Tucker, Bruner, Inc. ("Neidiger"), a firm _____ had worked with on other deals, to assume this role. However, in or about August 1994, Neidiger informed _____ that it would not be able to participate. (Tr. 189.) When _____ learned of this development, he panicked because _____ did not have sufficient capital to do the underwriting without Neidiger. (Tr. 189.)

On August 22, 1994, _____ informed ZCL that _____ had failed to secure a lead underwriter for the proposed firm commitment underwriting. (CE 56.) _____ therefore proposed that _____ conduct a private placement of ZCL securities in lieu of a firm commitment underwriting. (Id.) On August 24 and 26, counsel for ZCL wrote to _____ to clarify the status of the ZCL engagement

⁶ The Houston Branch Office moved locations during this time, and the build out of the separate space for corporate finance was at the new location. Before that, _____'s activities were segregated within _____'s office. (TR. 204-

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and several other projects with which they were involved on behalf of other clients. (CE 56; CE 57.) In each case the law firm represented that _____ made various commitments on behalf of _____. (CE 57.) _____ responded by letter dated August 30, 1994, denying that _____ was aware of _____'s activities and disavowing her authority to act on the Firm's behalf. (CE 58.)

_____ blamed _____ for _____'s problems with the ZCL underwriting, and, fearing the consequences of not being able to meet ZCL's expectations, he immediately disclaimed any knowledge of _____'s activities. He called _____ to hand him responsibility for _____ and the problems _____ attributed to her. _____ testified that _____ told him that _____ was "out of control." (Tr. 502.) _____ also testified that _____ told him that _____ had obligated _____ to a firm commitment underwriting that would result in the Firm going out of business.⁷ (Id.)

_____, upset by _____'s call, immediately went to _____'s office and demanded that she report on her corporate finance activities and that she call _____ and fill him in on what she was doing. (Tr. 191, 502.) Thereafter, _____ prepared several status memoranda dated August 29, 1994, covering the projects she was working on, which she gave to _____. (Tr. 186-91; 502.) _____ investigated _____'s allegations and determined that his account was inaccurate. (Tr. 503.) _____ found that _____ had approved all of _____'s activities, including the ZCL firm commitment underwriting. (Id.) Once _____ made this evaluation, he had no further direct involvement with _____ and the corporate finance department.

05.)

⁷ As a consequence, _____ suspended all corporate finance activities. (Tr. 175, 191.)

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By April 1995, _____ became dissatisfied with his role as _____'s President. (Tr. 454-55.) He disliked the retail side of the business and wanted to concentrate on corporate finance. He therefore struck a deal with the Firm to resign as President and form a new company called Vantage Corporation ("Vantage"). (Tr. 455.) Under this arrangement, all of _____'s new corporate finance business would go through Vantage, and _____ would handle the resulting distribution.⁸ (Tr. 454, 491.)

With the formation of Vantage, the pre-existing corporate finance department became an orphan. _____ did not like _____, and he did not invite her to join the Vantage team. In fact, she and _____ did not learn of _____'s departure and the creation of Vantage until late May, about one month after the change took effect. (Tr. 489-91.) _____ learned of the change by a memorandum that had been mailed to everyone at the Firm. (Tr. 490.) The news upset her terribly because it appeared to her that she was going to be fired. She immediately went to _____ to ask him what he knew about her position at the Firm, but he had not yet seen the memorandum, and he knew nothing about _____'s departure.⁹ (Id.) _____ testified that he also concluded that it looked like _____ was through. _____ then called _____, and they got into a heated disagreement about the Firm's decision to exclude _____ from corporate finance. _____ thought that the decision to exclude _____ was unfair.¹⁰ According to _____, _____ then suggested that they meet to discuss it further. (Tr. 491.)

⁸ _____ did not attract any new corporate finance business after May 1995.

⁹ _____ testified that he had not yet seen the memorandum when _____ "came screaming" into his office. (Tr. 490.)

¹⁰ _____ also testified that he was concerned because of his personal financial interest in keeping _____ as a lessee at the Houston Branch Office.

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_____, _____, _____, two members of the board of directors, and _____¹¹ met on June 8, 1995, to clarify _____'s status following _____'s departure. At the meeting, they decided to create a Corporate Finance Committee ("Finance Committee") and allow _____ to continue to work on her existing deals. (Tr. 491-93.) They also agreed to permit her to bring in new business, but each deal would first have to be approved by the Finance Committee. If the Finance Committee turned down a corporate finance opportunity _____ originated, she was then free to take it to a competing broker-dealer. (*Id.*) Thereafter, _____ continued to work on the existing corporate finance projects until she left the Firm in 1998.

3. _____'s Supervisory System Relating to Corporate Finance

According to the NASDR Staff Examiner who conducted the routine examination of _____, its supervisory system as it applied to its corporate finance activities was inadequate. He testified that from his routine examination and the spin-off examination of the Houston Branch Office he was never able to get a clear picture of "who was responsible for exactly what." (Tr. 102-03.) He spoke to 13 people during his examination who, he testified, pointed to various people at various times as having supervisory responsibility for the Firm's various business activities. (*Id.*) From these conflicting reports, he concluded that _____ did not have clear lines of supervision, particularly in the branch offices. (Tr. 104-05.) As a result of this confusion, and the lack of documentation delineating supervisory responsibility for the corporate finance department, the NASDR Staff Examiner elected to rely on _____'s account of the system, including who was responsible for _____'s supervision. (Tr. 107.)

¹¹ _____ was a securities lawyer. He and _____ owned 51% of Vantage and _____ owned 49%.

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From _____'s account, the NASDR Staff concluded that _____ was her supervisor—"at least with respect to her general securities business." (Tr. 108.) The examiner was not, however, able to make a definitive determination of who supervised _____ in her corporate finance activities.

From the evidence Enforcement introduced at the hearing, the Hearing Panel finds that _____ was responsible for corporate finance and that he was _____'s supervisor during his tenure at the Firm.¹² _____ herself testified that _____ was highly involved in all of her corporate finance projects and that she considered _____ to be her supervisor. (Tr. 181.) _____ corroborated her testimony. (Tr. 460.) According to _____, when _____ came on board he announced to _____'s board of directors that he was taking over corporate finance and that he would supervise _____. (Id.) On the other hand, there is no evidence that _____ had any role in corporate finance or _____'s supervision with respect to her corporate finance activities. _____ testified that _____' supervisory responsibilities were limited to his routine duties as a branch manager. (Tr. 461-62.) To the best of his recollection and understanding those duties involved such things as "initialing tickets, checking correspondence, watching trades for churning, excess activity, suitability, things of that nature." (Tr. 462.) All of the duties and activities _____ identified applied only to _____'s retail brokerage business. (Tr. 464.) For example, while _____ was responsible for reviewing her retail brokerage correspondence, _____ was responsible for reviewing her corporate finance correspondence. (Id.) According to _____, _____ was "part of the process of supervising [_____] as a retail registered representative." (Tr. 470.)

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The only evidence contradicting _____'s, _____'s, and _____' testimony that _____ was the head of corporate finance and _____'s supervisor between January 1994 and May 1995 is _____'s denial. Enforcement introduced copies of the transcripts of _____'s on-the-record interviews taken on March 27 and September 15, 1997. (CE 63A.)¹³ At his interviews, _____ testified that he had no responsibility whatsoever for the Houston Branch Office. According to _____, he felt that the branch was poorly run and should be closed. (CE 63, March 27, at 36, 38.) He also testified that he repeatedly recommended that _____ fire _____, but _____ refused. (CE 63, March 27, at 42.) _____ considered _____ an incapable manager. (CE 63, March 27, at 40.) According to _____, as a result of these differences of opinions, _____ retained responsibility for the Houston Branch Office and _____. (CE 63, March 27, at 38, 41.)

When _____ left _____ in May 1995 to set up Vantage, the supervision of corporate finance became even less clear. At this point, _____ testified that _____ came to him and said that they should "become co-supervisors of corporate finance" and form a Corporate Finance Committee to assist them since neither of them had a corporate finance background. (Tr. 456.) _____'s recollection is similar except that he testified that he did not assume any supervisory responsibility for _____ until he became a registered principal in November 1995. (Tr. 351-52.) According to _____, _____ had total supervisory responsibility for _____'s corporate finance activity between May and November. (Tr. 348.) Although both _____ and _____ testified that they felt that the Finance Committee had

¹² To supervise _____, _____ made frequent trips to Houston. (Tr. 202.)

¹³ References to the transcripts of _____'s on-the-record interviews are cited as follows: "CE 63A, [date], at ____."

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some overlapping supervisory responsibility for _____, neither could explain what those responsibilities were or how the Finance Committee carried out those responsibilities. (Tr. 469.)

_____ also could not say if the system he described met the requirements of NASD Rule 3010. (Tr. 470.)

With respect to _____' role, although _____ testified that he thought _____ had a greater role in _____'s supervision after _____ left the Firm, he was unable to define those added responsibilities. And both _____ and _____ admitted that neither of them ever told _____ that they expected him to assume greater responsibility after May 1995. (TR. 390, 413, 459.) In fact, when asked to explain _____' responsibilities, each could only point to his traditional role as a branch manager of the retail operations.

B. The Winstock Option Transaction

It is against the foregoing background concerning _____'s corporate finance business and supervisory structure that the Hearing Panel must view _____' alleged failure to supervise _____'s activities relating to the Winstock Option Transaction, which was structured under the following three agreements: the Winstock/_____ Option Agreement; the Agency Agreement; and the Escrow Agreement.

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1. Winstock/_____ Option Agreement

The evidence regarding the purpose and origin of the Winstock Option Transaction is unclear. The only explanation of the deal was offered by _____ based on his review of the available records.¹⁴ According to him, in early 1994, _____ (“_____”), President of Nevada Gold, a corporate finance client of _____,¹⁵ was negotiating with _____ (“_____”), President of Winstock, to acquire a parcel of land Nevada Gold needed in Blackhawk, Colorado, upon which it intended to build a casino. (Tr. 61, 118, 201, 357.) _____ was proposing to buy the property by issuing Winstock restricted shares of Nevada Gold.¹⁶ (Tr. 357.) _____, however, did not want to be left with restricted stock. He wanted the deal structured in a manner that would produce a cash flow of approximately \$20,000 per month. (*Id.* at 358.) To accomplish this, _____ speculated that Nevada Gold, through its affiliate, Aaminex Capital Corporation (“Aaminex”), devised a plan whereby Winstock would option up to five million shares of Nevada Gold stock to Aaminex.¹⁷ _____ further testified that this plan was implemented through a letter agreement dated April 9, 1994, between Winstock and _____ as agent for Aaminex.¹⁸ (JE 3.) Under the letter agreement, which was modified on July 30 and October 14, 1994 (JE 8; JE 11), the Nevada Gold stock owned by Winstock was to be acquired at predetermined

¹⁴ _____ had no first-hand knowledge of the background of the Winstock Option Transaction because he did not join _____ until April 1995.

¹⁵ _____’s father-in-law had introduced her to Mr. _____ in 1993 due to her interest at the time in entering the investment banking field. (CE 64, at 25.) That introduction led to Nevada Gold becoming a _____ client.

¹⁶ Nevada Gold was not publicly traded at the time.

¹⁷ No explanation was offered regarding Aaminex’s purpose in this transaction.

¹⁸ The agreement recites that _____ was acting as agent for an “undisclosed group of investors.” But she explained that she understood that to mean Aaminex and that she did not deal with any other investors. (CE 64, at 98, 106.)

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prices.¹⁹ Thus the agreement came to be referred to as the Winstock/_____ Option Agreement.²⁰

_____’s role under the Winstock/_____ Option Agreement, however, was spelled out in a separate letter agreement between her and Aminex.

2. The Agency Agreement

The Winstock/_____ Option Agreement does not detail _____’s relationship with Aminex. Instead, that relationship is actually spelled out in a letter from Aminex dated April 2, 1994 (“Agency Agreement”). (JE 2.) The Agency Agreement recites that it was intended to clarify Aminex’s proposal for her assistance in negotiating an option from Winstock to purchase up to five million shares of Nevada Gold common stock. The Agency Agreement further provided that, if the Winstock Option Transaction was successful, _____ would be entitled to the right to purchase 300,000 shares of Nevada Gold common stock at the prices set forth in the attached schedule. Aminex would receive the right to purchase two million shares and would be responsible for arranging for additional investors to subscribe for the “minimum payment due each month.”²¹ Finally, the Agency Agreement provides that Aminex agrees to loan _____ or her company up to \$350,000. The letter was signed by _____, who was President of Aminex as well as Nevada Gold.

¹⁹ To maintain the options, the holder of the options had to purchase a minimum of \$10,000 of stock each month for the first six months, \$15,000 of stock each month for the succeeding six months, and then \$20,000 of stock each month for the next succeeding 24 months. (JE 3, at 2.) All remaining unexercised options expired at the end of 36 months. (Id.)

²⁰ _____ was unwilling to say that the agreement legally created a true “option” because the rights under the Winstock/_____ Option Agreement terminated if the payments were not made timely.

²¹ The Agency Agreement does not define what minimum payment is due each month. The Hearing Panel concludes, however, that it is a reference to the required purchases under the Winstock/_____ Option Agreement.

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According to _____, she had no involvement in the negotiation of the Winstock/_____ Option Agreement. She testified at an on-the-record interview on February 21, 1997, that the underlying agreement between Winstock and Aaminex had been reached before _____ came to her on behalf of Aaminex and asked if she would function as agent “in optioning Nevada Gold stock from Winstock.” (CE 64, at 97-98, 106.) She further testified that she had no understanding of why Aaminex wanted to enter into the agreement and that the subject never came up in her discussions with _____. However, her general understanding was that Winstock wanted to option the stock it was receiving or had received from Nevada Gold as a result of the sale of the Black Hawk, Colorado property. (Id. at 100.) _____ also denied any knowledge of or involvement in Aaminex’s efforts to secure any additional investors to purchase the Nevada Gold stock subject to the Winstock/_____ Option Agreement. (Id. at 109-10.) From _____’s perspective, her involvement was uncomplicated. She was to act as Aaminex’s agent in presenting the Winstock/_____ Option Agreement to Winstock and thereafter, as and if requested, to forward payments to Winstock or its transfer agent and to request the issuance of the corresponding stock certificates. (Id. at 108, 112-116.)

With respect to the loan provision in the Agency Agreement, _____ explained that its purpose was to provide her with sufficient working capital while she was serving as Aaminex’s agent. Since her compensation under the Winstock/_____ Option Agreement was to be paid in options, she would not receive any cash income for her efforts on Aaminex’s behalf. (Id. at 116-17.)

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3. The Escrow Agreement

The third agreement comprising the Winstock Option Transaction is the Escrow Agreement dated December 29, 1994, among Winstock, _____, and Nevada Agency and Trust Company (“Nevada Trust”). (JE 12.) Under the Escrow Agreement, Nevada Trust acknowledged receipt of the shares of Nevada Gold common stock that Winstock had agreed to convey to _____ under the Winstock/_____ Option Agreement. Nevada Trust further agreed to send the stock certificates to _____ upon receipt from her of the payments called for in the Escrow Agreement and then remit the purchase money to Winstock.²² Consistent with the terms of the Winstock/_____ Option Agreement, if any of the monthly payments was not received, the options terminated and Nevada Trust was obligated to return the remaining certificates to Winstock.

The evidence shows that some of the payments followed the route contemplated, and others did not.²³ As to the payments that were made to _____ as agent under the Winstock/_____ Option Agreement, she generally deposited those payments in a checking account at First Prosperity Bank, which she had established to segregate the Winstock Option Transaction from her corporate finance activities within _____. Thereafter, at Aaminex’s direction, she sent the proceeds to Nevada Trust with instructions about the issuance of the corresponding stock certificates to the investors. Upon receipt of the funds, Nevada Trust sent the stock certificates to _____, who would, in turn, deliver them to the investors. (Tr. 155-56.) In accord with the Agency Agreement, while she held investor

²² Forty thousand shares had already been forwarded to _____, which were purchased with the October 1994 payment in the amount of \$20,000.

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funds in her First Prosperity Bank checking account, _____ booked a portion of the funds as a loan from Aaminex. (Tr. 163; CE 49.) The amount of the loans was the difference between what the investors paid and the amount due Winstock under the Winstock/_____ Option Agreement. (Tr. 281-82.) The difference belonged to Aaminex. (Id.) In each case the loan was recorded on the books of _____, and Aaminex immediately recorded the sale of the certificates on its books.

C. The Hearing Panel’s Assessment of the Evidence and Credibility Findings

The overwhelming evidence supports _____’ contention that he was not charged with _____’s supervision once she transferred to corporate finance. Not only is there no documentation to suggest otherwise, but _____, _____, and _____ each testified that _____ assumed responsibility for corporate finance, including _____’s supervision, when he joined the Firm in January 1994. Indeed, after _____ accused _____ of jeopardizing _____’s continued operations, _____ determined that _____ actually had approved each of the projects under her control. (Tr. 503.) By contrast, the Hearing Panel finds that _____’s account of his duties and responsibilities is inherently incredible and inconsistent with the documentary and other evidence offered by Enforcement at the hearing.

At his on-the-record interview on March 27, 1997, _____ disavowed all responsibility for _____ and the corporate finance department before the Fall of 1994. (CE 63A, March 27, at 91-92.) According to him, he told _____ that both _____ and _____ were incompetent and he, therefore, would not be responsible for them or their activities. _____ also disavowed all knowledge of the

²³ None of the investors lost any money due to the manner in which _____ handled their funds.

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Winstock Option Transaction. (Id. at 89-90.) _____ stated that _____ operated autonomously and that he was not therefore privy to a number of transactions with which she was involved. (Id.)

The Hearing Panel finds _____'s story incredible and totally unsupported by the other evidence. Both _____ and _____ testified that one of _____'s chief goals upon assuming the office of President of _____ was to build a corporate finance department. Indeed, corporate finance was _____'s main interest and the area in which he had the greatest expertise. On the other hand, _____, _____, and _____ had no corporate finance or investment banking experience. None of them was qualified to develop or supervise a corporate finance department. Only _____ had that expertise.

_____ 's story is further undercut by his own actions. First, shortly after arriving at _____, _____ negotiated a larger override from _____'s activities. (Tr. 184-85.) _____ testified that he justified his demand on the ground that he was going to work with her closely. (CE 64, at 125-26.) Second, it is undisputed that _____ made frequent trips to Houston to meet with _____. Indeed, _____ testified that he spent so much time with her on those trips that the brokers in the Houston branch became disgruntled. (Tr. 475.) The brokers felt that _____ was ignoring them and the retail side of the business. Third, _____ negotiated or was involved in the negotiations and approvals of _____'s corporate finance contracts. (Tr. 503.) _____ himself admitted in his on-the-record interview that he met with _____ in late 1994 to discuss the investment banking and consulting work

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_____ was to provide Nevada Gold.²⁴ (CE 63A, March 27, at 76.) Fourth, _____ received options to purchase Nevada Gold stock from _____ as a result of the Winstock Option Transaction.

_____’s story also is contradicted by the documentary evidence. For example, consistent with _____’s testimony, there is substantial documentation reflecting that _____ sent _____ regular written reports of her activities. (CE 54.) Those reports started at least as early as August 1, 1994. (Id.) On the other hand, there is no documentation supporting _____’s contention that _____ or _____ was responsible for _____’s supervision while _____ was at the Firm.

Finally, the Hearing Panel notes that _____ harbored a great amount of ill will towards _____, _____, and _____, which would give him a motive to mischaracterize their responsibilities once a problem was uncovered by NASD Regulation. As discussed above, _____ wanted _____ and _____ fired, but _____ refused his requests. And _____ attributed the loss of his position with _____ to _____ and his criticism of the Houston Branch Office. (CE 63A, March 27, at 66.) Moreover, both _____ and _____ testified that _____ was a bad fit. _____ described _____ as an egotistical, narcissistic, manipulative liar who had a hidden agenda to benefit himself at the expense of the Firm. (Tr. 475-76.) _____ substantially corroborated _____’s characterization and offered his opinion that _____ was more truthful than _____. (Tr. 440-42.)

²⁴ Despite this relationship, _____ denied that _____ ever mentioned the Winstock Option Transaction. (CE 64, March 27, at 76-77.)

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IV. Conclusions of Law

A. Jurisdiction

The NASD has jurisdiction of this proceeding. _____ was registered with the NASD at the time of the alleged violation and at the time Enforcement filed the Complaint.

B. Duty to Supervise

The duty of supervision derives from Section 15(b)(4)(E) of the Exchange Act (15 U.S.C. 78o(b)(4)(E)), which provides in part that a person associated with a broker-dealer²⁵ is subject to discipline if he has “failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. (Emphasis added.) Thus, to prove deficient supervision under Section 15(b)(4)(E), two elements must be found: First, the respondent must have been the supervisor of the person who violated the securities laws. Second, the respondent must have performed unreasonably in discharging his or her supervisory responsibilities. Both of these considerations require a fact specific inquiry.²⁶

With respect to the threshold question, persons are not considered “supervisors” solely because of the positions they occupy.²⁷ Whether a person is a “supervisor” for the purposes of Section 15(b)(4)(E) “depends on whether, under the facts and circumstances of a particular case, that person

²⁵ Section 15(b)(6) of the Exchange Act incorporates Section 15(b)(4)(E) by reference and allows the SEC to impose sanctions for deficient supervision on individuals associated with broker-dealers.

²⁶ In re John H. Gutfreund, 51 S.E.C. 93, 1992 SEC LEXIS 2939, at *46-47 (1992); District Bus. Conduct Comm. No. 7 v. Lobb, No. C07960105, 2000 NASD Discip. LEXIS 11, *17 (Apr. 6, 2000).

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has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.’²⁸ The Securities and Exchange Commission recently applied the same standard to the NASD’s rules.²⁹

As to the second consideration, it is not sufficient only to show that the respondent could have done better. A supervisor is liable for deficient supervision only if his actions are found to be unreasonable in light of all the attendant circumstances.³⁰ Moreover, Section 15(b)(4)(E) provides that no person shall be responsible for deficient supervision if he “reasonably discharged the duties and obligations incumbent upon him by reason of [his firm’s] procedures and system.” Thus, a factual analysis must be made in each case because different supervisors may have different responsibilities depending on how each firm devises its compliance program.³¹

NASD Conduct Rule 3010 is similar. It requires that members establish, maintain, and enforce a set of written supervisory procedures and that these procedures be "reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of [the] Association." In general, the Rule requires that each member firm establish both a supervisory system and written supervisory procedures that are tailored to the firm’s specific structure, and the NASD has

²⁷ Id.

²⁸ Id. at *47.

²⁹ In re Gordon Kerr, Exchange Act Release No. 43418, 2000 SEC LEXIS 2132, *11 (Oct. 5, 2000).

³⁰ In re Louis R. Trujillo, Exchange Act Release No. 26635, 1989 SEC LEXIS 480, *10 (Mar. 30, 1989).

³¹ In re Arthur James Huff, Exchange Act Release No. 29017, 48 S.E.C. Docket 767, 1991 SEC LEXIS 551, *11 (Mar. 28, 1991).

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identified certain elements that must be included in each such supervisory system.³² One minimum requirement under Rule 3010(a)(2) is that each member assign responsibility for each type of business that the member conducts to one or more principals and that the principals be appropriately registered and vested with the authority to carry out the supervision for which they are responsible.³³ The purpose of this requirement is to “ensure that there is an identifiable individual who has ultimate responsibility for implementing the member’s supervisory system and written procedures for each type of business the member conducts.”³⁴ Although the member is ultimately responsible for supervision, where the supervisory system and written procedures allocate that responsibility to registered persons at the firm, they become accountable for those supervisory responsibilities to which they are assigned.

A second requirement under Rule 3010(a)(5) is that each registered person must be assigned to at least one qualified supervisor. The purposes of this Rule are to provide the registered person with a clear line of authority and to specifically identify for the supervisor the persons for whom he or she has responsibility.³⁵ An assigned supervisor of a registered person may be found liable for violating Rule 3010 if he or she fails to discharge that responsibility in a reasonable manner.³⁶ The burden is on Enforcement to show that the respondent acted unreasonably.³⁷

³² NASD Notice to Members 99-45.

³³ Id.

³⁴ Id.

³⁵ Id.

³⁶ See, e.g., In re. Christopher J. Benz, Exchange Act Release No. 38440, 1997 SEC LEXIS 672 (Mar. 26, 1997).

³⁷ See, e.g., Lobb, 2000 NASD Discip. LEXIS 11, *17.

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C. _____'s Supervision

In the Complaint, Enforcement alleged that _____ committed three separate violations by her participation in the Winstock Option Transaction. First, Enforcement contended that she mishandled investors' funds by commingling them in her corporate money market account at _____. (Compl. ¶ 16.) Second, Enforcement contended that her activities were private securities transactions and that she had not given _____ written notice of them as required by the NASD Rule 3040. (Compl. 19.) Third, Enforcement alleged that her activities amounted to effecting securities transactions for the account of others for which she should have been registered as a broker-dealer since she was not acting as a General Securities Representative with _____. (Compl. ¶ 13.)

According to Enforcement, these alleged violations were foreshadowed by four "red flags" that were visible to _____ in his capacity as the branch manager of the Houston Branch Office. Under Enforcement's theory, although _____ was not charged with the responsibility to supervise _____'s corporate finance activities, he nevertheless might have been able to prevent her violations if he had responded to the red flags. Consequently, Enforcement argues that he should be deemed to have had supervisory responsibility to prevent her violations.

Enforcement relies on the case of In re John H. Gutfreund, 51 S.E.C. 93, 1992 SEC LEXIS 2939 (1992). In Gutfreund the SEC, along with its order accepting settlements imposing sanctions on three of the top executives at Salomon Brothers, Inc. ("Salomon"), issued a Report of Investigation

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Pursuant to Section 21(a) of the Securities Exchange Act of 1934³⁸ regarding Salomon's Chief Legal Officer ("Report"). The Gutfreund case arose out of serious allegations of criminal conduct on the part of Salomon's Government Trading Desk. The three senior executives were not charged with participation in the underlying criminal conduct. Instead they were charged with inadequate supervision under Section 15(b)(4)(E) of the Exchange Act. Salomon's Chief Legal Officer, on the other hand, was not charged at all. Nevertheless, because the SEC considered it a good case to "amplify [its] views on the supervisory responsibilities of legal and compliance officers in [Salomon's Chief Legal Officer's] position," it issued the Report concerning his supervisory responsibilities under the facts and circumstances of that case.³⁹

In the Report, the SEC first emphasized that legal and compliance personnel who are not direct line supervisors do not become "supervisors" merely because of the positions they occupy.⁴⁰ "Rather, determining if a particular person is a 'supervisor' depends upon whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue."⁴¹ The SEC went on to state that serious misconduct involving a senior official at the firm had been brought to the attention of

³⁸ Section 21(a) of the Exchange Act authorizes the SEC to investigate whether any person has violated the Exchange Act and the rules thereunder and, in its discretion, to publish a report concerning such investigations.

³⁹ Gutfreund, 1992 SEC LEXIS 2939, at *46.

⁴⁰ Id. at *47.

⁴¹ Id.

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Salomon's Chief Legal Officer, and, in such a situation, a person with his "role and influence" "shared in the responsibility to take appropriate action to respond to the misconduct."⁴²

From this discussion, Enforcement centers on the SEC's use of the phrase "affect the conduct of the employee whose behavior is at issue." In other words, Enforcement argues that the Gutfreund Report stands for the proposition that managers may become responsible for the supervision of persons not under their direct supervision if they become or should have become aware of indications of improper behavior or "red flags." The Hearing Panel disagrees with this conclusion.

In the Hearing Panel's opinion, Enforcement's reading of Gutfreund is far broader than what the SEC intended. Indeed, if accepted, Enforcement's position would leave managers in an untenable position. Under Enforcement's interpretation, managers would have to second guess their co-managers' supervision. The Report does not go that far. In the Hearing Panel's opinion, the Report is properly limited to the facts and circumstances presented in that case. Salomon's Chief Legal Officer had a unique "role and influence" in the management of the firm that required that he act when directly confronted with evidence of serious criminal conduct. There is nothing in the Report to suggest that the SEC intended the principles set out in that portion of the case to apply to a case such as this one. In any event, even if the Report is considered to be applicable to the facts and circumstances of this case, for the reasons discussed below, the Hearing Panel finds that Enforcement failed to prove that the so-called "red flags" evidenced any wrongdoing that _____ ignored. And, since _____ was not otherwise charged with _____'s supervision, he did not violate NASD Rule 3010, as alleged in the Complaint.

⁴² Id. at 48 (emphasis added).

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1. Receipt of Nevada Gold Options

The first factor Enforcement terms a red flag is _____' receipt of 25,000 options to purchase Nevada Gold common stock under the terms of the Winstock/_____ Option Agreement. _____ received the options from _____ pursuant to an Assignment dated June 1, 1994. (JE 6.) The Hearing Panel notes that at the same time _____ assigned 10,000 options to _____. (JE 5.)

The Hearing Panel finds, however, that there is nothing about the receipt of the options that can be considered a "red flag" or an indication of an impropriety. As discussed above, _____ and _____ were entitled to a percentage of everything _____ earned as a result of her corporate finance activities. _____ and _____ each testified that he was entitled to 10% of all of her earnings, which was designed to cover her rent for the office and equipment. (Tr. 123; 517-18.) In the case of the Winstock Option Transaction, _____ received options rather than stock, and she paid _____ and _____ in kind. Thus, there was nothing unusual in the assignment of the options to _____, and _____—even assuming he had some supervisory responsibility for _____—cannot be faulted for failing to investigate the Winstock Option Transaction simply because he received these options.

2. _____'s Staff

The second factor Enforcement points to also is not an indication of wrongdoing that required investigation. Enforcement argues that _____ should have been suspicious of the fact that _____ employed two persons in corporate finance although she did not have any retail brokerage income. Enforcement's assumption is that _____ should have concluded that the only funds available to _____ came from her retail brokerage business, which she discontinued after she moved into the

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corporate finance department. But there was no evidence that _____ ever learned that _____ had financial problems. Furthermore, _____ was not privy to the financial arrangements _____ had established with _____. _____ also had no reason to believe that _____ could not have obtained adequate financing from outside sources. Accordingly, there was nothing about the employment of these two individuals that should have caused _____ to go to _____ or _____. Moreover, _____ had no reason to believe that _____ and _____ were not overseeing her operations.

3. The Houston Branch Office Blotters

The third “red flag” Enforcement contends _____ ignored was the entries on the Houston Branch Office blotters, which reflected numerous checks received from and sent to Aaminex. (Response to Mot. for More Definite Statement at 3.) Here, however, Enforcement’s argument falls short for two reasons. First, there is no evidence that _____ actually saw the entries.⁴³ Second, _____ had delegated daily review of customer checks to the principal who oversaw the back office operations at the Houston branch.

The NASD Regulation Staff Examiner testified that the Houston Branch Office’s operations department received the mail, completed the blotters, forwarded the checks to the clearing firm, and requested the clearing firm to issue checks. (Tr. 46.) _____ did not review the blotters, his operations manager did. (Tr. 580.) Further, when checks were received by the operations department they were logged into _____’s system so that they would also be reviewed in Denver. (Tr. 580-81.) The

⁴³ In this regard it is significant that _____’s account was a money market account. (JE 1.) No securities were bought or sold through this account.

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Houston office's operations department also overnighted a copy of the checks and the blotters to Denver daily. (Tr. 581.) To _____' knowledge it was then _____'s responsibility to review the activity in _____'s account. (Tr. 585.) And once _____ left the Firm, _____ believed that the newly formed Finance Committee was responsible for reviewing _____'s activities. (Tr. 587.) Importantly, as discussed above, _____ was never told that he was responsible for reviewing _____'s account once she transferred to the corporate finance department.

Under these circumstances, the Hearing Panel concludes that _____ did not act unreasonably. He was not charged with the responsibility of reviewing _____'s account, and he had properly delegated supervision of the operations department to a qualified registered principal who did not alert _____ to any possible irregularities.

4. Review of Correspondence

Enforcement's final argument is that _____ ignored red flags that were or should have been caught through review of _____'s incoming and outgoing correspondence. But here again, the Hearing Panel concludes that Enforcement failed to show that _____ was aware of, or should have been aware of, any suggestions of impropriety.

First, as to _____'s outgoing correspondence, the record clearly shows that _____ was not charged with reviewing this correspondence after _____ moved to corporate finance. (Tr. 566-67.) In fact, _____ properly refrained from such review in compliance with the Firm's Chinese Wall requirements.

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Second, as to her incoming correspondence, _____ testified that the operations department opened and sorted the mail received in the branch office. (Tr. 548-49.) Early on, after _____ left the retail side, _____ verified that he and his department should not review any incoming corporate finance correspondence sent to _____.⁴⁴ (Tr. 549.) Thereafter, _____ had nothing to do with her correspondence. (Id.) For that reason, there is no evidence in the record that _____ ever saw any signs of suspicious activity regardless of whether it would have been his responsibility to follow up on such red flags if he had discovered them. And there is no evidence that anyone else at the Firm ever alerted _____ to any of _____'s alleged improprieties.

V. Order

Based on the foregoing, the Hearing Panel concludes that Enforcement failed to establish the charges against _____ by a preponderance of the evidence. Accordingly, the Complaint against _____ is dismissed.⁴⁵

Andrew H. Perkins
Hearing Officer
For the Hearing Panel

⁴⁴ Most of this correspondence was sent directly to _____'s separate address, and therefore it did not go through the operations department.

⁴⁵ The Panel considered all the arguments of the Parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the findings herein.