NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C3A000054
v.	:	
	:	Hearing Officer - AWH
ROBERT M. McCULLEY (CRD #725980),	:	**Hearing Panel Decision**
Fort Collins, CO	:	
Loveland, CO	:	
	:	June 28, 2001
Respondent.	:	

Registered principal and representative failed to provide member firm with prompt written notice of outside business activity. Respondent found liable for violation of Conduct Rules 2110 and 3030, fined $15,000, and suspended from associating with any member firm in any capacity for 10 business days.

Appearances:

Roger D. Hogoboom, Jr., Esq., for the Department of Enforcement

Martin M. Berliner, Esq., for Robert M. McCulley

DECISION

Introduction

On December 22, 2000, the Department of Enforcement issued the Complaint in this matter, alleging that Robert M. McCulley ("McCulley" or "Respondent") engaged in outside

business activities without giving prompt written notice to Royal Alliance Associates, Inc. ("Royal Alliance"), the member firm of the NASD with which he was associated. On January 16, 2001, McCulley filed his Answer to the Complaint. On March 13, 2001, Enforcement filed a Motion for Summary Disposition, to which McCulley responded on March 30, 2001. In his Response, McCulley stated that he did not oppose the Motion as to the issue of liability only, but that he did take issue with the sanctions sought by Enforcement.

A hearing was held in Denver, Colorado, on May 8, 2001, before a Hearing Panel composed of the Hearing Officer and two current members of District Committee No. 3. At the hearing, the Motion for Summary Disposition was granted as to the issue of liability, and the hearing was limited to the issue of the appropriate sanctions to be imposed.

Findings of Fact

From November 1989 until May 1998, McCulley was associated with Royal Alliance and registered with the NASD as a Series 7, General Securities Representative, and a Series 24, General Securities Principal. Because he is currently associated with member firm Excalibur Financial Group, Inc., he is subject to the jurisdiction of the NASD for purposes of this Complaint, pursuant to Article V, Section 2 of the NASD By-Laws.

McCulley started with Royal Alliance as a registered representative, and within a couple of years, became a branch manager. In 1997, he turned over the 12 brokers under his supervision to another manager because he wanted to return to personal production. Tr. 28. [1] Typically, half of his income was derived from Royal Alliance, half from his outside business

[1] Reference to Complainant's exhibits are marked CX_; references to the hearing transcript are marked Tr._.

activity, such as sales of life and health insurance, insurance company fixed and indexed annuities, and mortgage related services. Tr. 66; CX-2 and 3.

The undisputed facts demonstrate that from approximately May 1997 through November 1997, McCulley sold to his customers 23 limited liability partnership interests in a Registered Limited Liability Partnership ("RLLP") known as Prestige Partners. He received compensation of approximately $109,307.00 for those sales which were outside the scope of his employment with Royal Alliance. He gave Royal Alliance written notice of those sales on February 3, 1998, more than eight months after his first sale of an interest in Prestige Partners. At least three of McCulley's customers who purchased interests in Prestige Partners were customers of Royal Alliance. *See* Declaration of Edward Glottstein and Statement of Undisputed Facts. All purchasers of the partnership interests were McCulley's higher net worth clients. Tr. 34. McCulley gave each customer who purchased an interest in Prestige Partners a "Disclaimer" that stated: "I am aware that Robert M. McCulley is associated with Royal Alliance Associates as his current Broker Dealer and that this program is not part of Royal Alliance Associates." CX 7, at 6; Tr. 40. McCulley had no proprietary or beneficial interest in Prestige Partners, other than the commissions he received for selling the interests.

Nature of the Prestige Partners Investment

Prestige Partners is a Registered Limited Liability Partnership, formed under the laws of the State of Colorado, whose purpose is to purchase uncollected pools of consumer debt charged off by financial institutions. The pools of debt are then placed for collection with a Denver law firm which utilizes its connections with a network of law firms in other states. The

amounts collected above the deeply discounted cost of the pooled debt provides income to the partnership. CX-4, at 24; Tr. 29-30.

Although denominated and registered as a "limited liability partnership," Prestige Partners is, in fact, a general partnership. It was formed under a Colorado law that affords a certain limited liability to general partners. The Prestige Partners general partners are specifically charged with active participation in the management of the business, and they do not expect profits to arise solely from the efforts of the promoter or a third party. A legal opinion obtained by the firm responsible for collecting the pooled debt concluded that such an RLLP general partnership interest should not be considered a security under the Securities Act of 1933 or the Securities Exchange Act of 1934. CX 4, at 19. Enforcement does not claim such interests to be securities, and McCulley is not charged with selling away. Tr. 68-69. There is no evidence that Prestige Partners is other than a legitimate business, and there is no evidence of any customer complaints about their purchases or performance of the partnership interests.

Respondent's Reports of Outside Business Activity

Annually, at about the same time each year over a ten-year period, Respondent had been reporting any outside business activity to Royal Alliance on forms that specifically cited the requirement of NASD Conduct Rule 3030 that a registered representative shall not engage in outside business activities unless the representative has "made prompt written notification" to Royal Alliance. CX 5, at 10. That same form notes that Royal Alliance will provide written acknowledgment of such notification, and that it "reserves the right to object to, or place conditions on, business activities that constitute a conflict of interest to [the representative's] association with the firm." *Id*. An April 15, 1996, notice from Royal Alliance approving

McCulley's request to engage in outside business activities stated: "NOTE: You are not permitted to engage in an Outside Business Activity without **prior approval from the Royal Alliance Compliance Dept**." (emphasis in the original) CX 2.

The outside business activity form was part of a package that Royal Alliance sent to McCulley each year in January. He would perform a self-audit of his office and his satellite office, noting any outside business activities in which he or the office staff were engaging. CX 5, at 10-13; Tr. 31. A Royal Alliance compliance officer would also visit McCulley's office on a yearly basis. Tr. 35. In a 1996 discussion during one of these visits, McCulley, who had for years been engaged in selling insurance as an outside business activity, asked the compliance officer how important the forms were in view of his repeated disclosure of his insurance activities. The compliance officer stated that Royal Alliance was looking for, and did not want representatives to engage in, any securities transactions. "Activities outside of securities were not near as important as securities." Tr. 35-6.

On March 13, 1997, McCulley submitted his annual Request to Engage in Outside Business Activity, and a Business Activity Questionnaire. CX 5, at 10-11. As noted above, McCulley began selling interest in Prestige Partners in May 1997. He did not notify Royal Alliance of his activities with respect to Prestige Partners until he submitted his next annual Request to Engage in Outside Business Activity, dated February 3, 1998. CX 5, at 12-13. Based on the past practice, McCulley was under the impression that he was giving Royal Alliance "prompt" notice of his activity with Prestige Partners. CX 5, at 1; Tr. 55. On February 13, 1998, Royal Alliance wrote to McCulley, seeking more information about the sale of limited liability partnerships. CX 7, at 3. In other years, Royal Alliance had also requested

more information on certain outside business activities. McCulley responded immediately to those requests. Tr. 38. McCulley replied on February 18, 1998, explaining the program and enclosing the disclaimer form that notified customers that Royal Alliance was not part of the Prestige Partners program. CX 7, at 4-6. By memorandum dated February 26, 1998, Royal Alliance notified McCulley that Prestige Partners was not an approved product according to the Royal Alliance Product Guide and that he was not to engage in any sales of the investment. The memorandum stated: "Although you noted that clients sign a form acknowledging that they are aware that Royal Alliance Associates is not involved, the sale of this investment to clients is considered selling away and is therefore in violation of Royal Alliance and NASD policy. You must not sell this Limited Liability Partnership to any clients or your Royal Alliance registration will be terminated." CX 8. McCulley immediately stopped selling interests in Prestige Partners. Tr. 44.

McCulley left Royal Alliance and became associated with Excalibur in June 1998, when his office lease was coming up for renewal and he wanted to move into another building. He associated with a good friend with whom he had been sharing office space, and with a member firm (Excalibur) that dealt in sales of mutual funds and variable annuities, the only securities products he had been dealing in with Royal Alliance. Although McCulley's CRD record indicates that Royal Alliance "discharged" McCulley in May 1998, there is no evidence of the reasons or circumstances of the discharge. CX 1, at 2. The February 26, 1998, memorandum notifying McCulley to stop selling Prestige Partners interests indicates that Royal Alliance must have been under the misimpression that the partnership interests were securities, because it considered the sale of those interests to constitute selling away.

The NASD's investigation of McCulley's sales of Prestige Partners interest resulted from an audit of McCulley's office by the Securities and Exchange Commission. The SEC then referred the matter to NASD Regulation, Inc. Tr. 69.

Discussion

NASD Conduct Rule 3030 mandates that "[n]o person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of Rule 3040 shall be exempt from this requirement."

The purpose of Conduct Rule 3030 is to provide member firms with prompt notice of outside business activities so that the member's objections, if any, to such activities can be raised at a meaningful time and the member can exercise appropriate supervision as necessary under applicable law. *Proposed Rule Change by NASD Relating to Outside Business Activities of Associated Persons*, Exch. Act Rel. No. 34-26063, 1988 SEC LEXIS 1841 (Sept. 6, 1988). Because Royal Alliance was not given notice of McCulley's sales of Prestige Partners interest until some eight months after he began selling those interests, Royal Alliance was not given a meaningful opportunity to review his activity and determine the extent, if any, to which it should supervise those sales. Accordingly, McCulley, as he does not dispute, violated Conduct Rule 3030.

A violation of another Commission or NASD rule or regulation constitutes a violation of Conduct Rule 2110. *Steven J. Gluckman*, Exch. Act Rel. No. 41628, 1999 SEC LEXIS

1395 at *22 (July 20, 1999) (citations omitted). A finding of intent or scienter is not required when the violation of Conduct Rule 2110 stems from the violation of another rule or regulation. *Id*. Accordingly, by virtue of his violation of Conduct Rule 3030, McCulley violated Conduct Rule 2110.

Sanctions

At the time Enforcement's Motion for Summary Disposition was filed in March 2001, the 1998 edition of the NASD Sanction Guidelines was in effect. In the Motion for Summary Disposition, Enforcement took the position that this was not an egregious case that called for a bar or a lengthy suspension. It requested that for the violations in this case, McCulley be fined $10,000.00, suspended for 10 business days, ordered to disgorge the $109,307.00 that he received in commissions on the sale of Prestige Partners interests, and ordered to requalify by examination. At the time of the hearing, the 2001 edition of the NASD Sanction Guidelines was in effect. Enforcement amended its request for sanctions to reflect the change in the Sanction Guidelines for violations of Conduct Rule 3030 which provided as follows: "In egregious cases, including those involving sales of financial products, [Adjudicators should] consider a longer suspension (of up to two years) or a bar." NASD Sanction Guidelines 18 (2001 ed.). Because the new Guidelines treat the sale of a financial product as an egregious case, and because Enforcement wanted to modify its request for relief after its review of McCulley's strained financial situation (discussed below), Enforcement requested at the hearing that McCulley be fined only the amount of his financial benefit, *i.e*., $109,307.00, that he be suspended for 180 days, and that he be ordered to requalify as a general securities principal by examination.

Counsel for McCulley argues that although McCulley violated Conduct Rule 3030, he did not do so with any intent to violate it or with any base or malicious motivation. Counsel also points to McCulley's financial situation, arguing that he cannot afford (nor should he be required in any event) to be fined an amount equal to his commissions on the Prestige Partners interests. Had McCulley not sold those interests, he would have sold those clients another product that was not subject to the fluctuations of the stock market, which would have been a product outside of the business of Royal Alliance. Accordingly, counsel argues that Royal Alliance was not deprived of any income as a result of McCulley's sales of Prestige Partners. Counsel finally argues that suspension for 180 days is harsh, given McCulley's financial circumstances, and that an order to requalify by examination is not remedial because there is no question that McCulley knows what the rules require, but that he erred in following his past practices with Royal Alliance.

The Hearing Panel focused on two of the General Principles applicable to all sanction determinations: (1) that disciplinary sanctions are remedial in nature and should be designed to deter future misconduct and to improve overall business standards in the securities industry; and (2) that the recommended ranges in the guidelines are not absolute, and that depending on the facts and circumstances of a case, Adjudicators may determine that no remedial purpose is served by imposing a sanction within the range recommended in the applicable guideline. NASD Sanction Guidelines 3, 5 (2001 ed.).

Turning to the particular Sanction Guideline for violations of NASD Conduct Rules 2110 and 3030, the Hearing Panel finds two principal considerations to be applicable to the facts of this case. The first is that the outside activities involved both customers of the member

firm and purchasers who were not customers of the firm. While outside activity involving customers of the firm is an aggravating factor, the Hearing Panel finds as a mitigating factor McCulley's distribution to each customer of a disclaimer stating that the product was not associated with the employer. He did not attempt to create the impression with any customer that his employer sanctioned the outside activity.

The second consideration is that the outside activity involved a financial product. Although the sale of a financial product is an aggravating factor, the Hearing Panel considered the atypical features of the product involved in this case, which sought to provide a maximum of partnership control over the partnership and its on-going management. All partners have all the rights of a general partner including, but not limited to: (1) the right to terminate the partnership and/or his or her interest in the partnership and to seek an accounting; (2) the right to remove the managing general partner and replace him with any other general partner; (3) the right to direct the managing general partner's activities; and (4) the right by a vote of two-third's of the partnership to amend the partnership agreement. In addition, material actions, such as pledging assets, borrowing money, and executing commercial paper, cannot be taken in the absence of a two-third's vote at a partnership meeting. Finally, there are restrictions on the transferability of all partnership interests. There is essentially no transferability except to family members or to affiliates, and even then, any transfer must be approved by the partnership. CX-4, at 35-36. In short, the interest which each partner purchases is virtually an active business interest.

The Hearing Panel also considered the following mitigating facts to be important to determining the appropriate sanctions: Respondent accepted responsibility for his conduct; he ceased the conduct immediately upon his employer's direction; he never attempted to conceal

his conduct or to mislead regulatory authorities; there is no evidence of injury to other parties; he cooperated with NASD Regulation in the investigation; and he believed he was complying with his firm's procedures for reporting outside business activity. *See* Sanction Guidelines at 9, 10.

Finally the Hearing Panel assessed the credibility and character of the Respondent. After giving due consideration to the evidence, Respondent's demeanor, and his testimony, the Hearing Panel finds McCulley to be a credible witness who, through this proceeding and its consequences, has already paid a price, both emotionally and financially. His contrition is genuine. Asked why he did not get prior approval from Royal Alliance before selling partnership interests, he was candid in his answer:

> I'm not sure I have a good answer for you other than the fact that the types of things that I had been doing in the past were the way I had done it. I had just done it the same way all along. And perhaps back in 1987 or '88, the questionnaires may not have been as detailed, and I probably – obviously, should have read them more clearly. I don't have a good reason for that. I just screwed up, I guess.

Tr. 64-65.

When asked what affect the investigation and enforcement proceeding has had on his ability to earn a living, he responded as follows:

> Well, it's a very emotional thing. The fact of being accused of doing anything like this has made it difficult to work and subsequently affected my income. This is something of an attitude business. And if my attitude is not up, it's difficult to see people. So it's been – financially, it's been pretty devastating.

Tr. 45.

In 1997 and for some years preceding, McCulley's net income was typically $60,000 to $80,000 per year. Tr. 62. However, in 1999, his expenses exceeded his income by $12,000, and in 2000, although he expected to earn $60,000, he earned only $30,000.[2] Tr. 47-48. At the time of the hearing, his bank account had less than $1,000; his IRA was worth about $8,000, he had $55,000 of equity in his $200,000 house, $51,000 of equity in a non-liquid limited partnership, and $55,000 in three automobiles (including one that he purchased for his mother-in-law). Tr. 47-49.

In considering whether to order McCulley to disgorge all or some of his commissions from the sale of Prestige Partners interests, the Hearing Panel has distinguished the facts in this case from those in *DOE v. Testino*, No. C3A990031 (OHO Oct. 3, 2000), *at* http://www.nasdr.com. That case, which involved charges of selling away, found that evidence of the respondent's financial circumstances was insufficient to show that he could not disgorge the full amount of commissions earned. On remand from the National Adjudicatory Council, Testino was fined $10,000 and ordered to disgorge the $167,000 he earned from selling notes. Here the evidence of McCulley's financial circumstances is undisputed, and demonstrates that his income and assets are sufficient only to pay a total fine at the lower end of the range suggested by the Guidelines. *See* NASD Guidelines 18 (2001 ed.). Accordingly, the Hearing

[2] McCulley's financial statement that was prepared for this hearing estimated his income at $60,000. However, after completing his income tax returns, he discovered that his estimate was considerably optimistic. Tr. 47.

Panel concludes that McCulley should pay a fine of $15,000, which includes the amount of McCulley's financial benefit that is within his ability to pay, and which is considered to be remedial and not punitive.[3] There was no firm involvement in the sales of the partnership interests, and the customers who bought them, all having a high net worth, were specifically told that the firm was not involved with the product. Giving consideration to all the mitigating factors noted; his strained financial circumstances, including his ability to earn a living; and the remedial purpose of sanctions, the Hearing Panel concludes that McCulley should be suspended from associating in any capacity with a member firm for a period of ten business days, but that he should not be required to requalify by examination. Given the unique circumstances of this case, the Hearing Panel believes that the sanctions are sufficient to deter future misconduct and improve the overall business standards in the securities industry.

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

[3] The Hearing Panel did not accept Counsel's argument in opposition to disgorgement that the firm did not lose money because Respondent, in any event, would have been selling an outside product. The purpose of disgorgement is not to address lost income to the firm, but to deter misconduct by ensuring that a respondent does not profit from a rule violation.

become effective with the opening of business on Monday, August 20, 2001 and end at the close of business on Friday, August 31, 2001.

SO ORDERED.

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Alan W. Heifetz
Hearing Officer
For the Hearing Panel

Copies to:

Via First Class Mail & Overnight Courier
Robert M. McCulley

Via First Class Mail & Facsimile
Martin M. Berliner, Esq.

Via First Class & Electronic Mail
Roger D. Hogoboom, Jr., Esq.
Rory C. Flynn, Esq.