NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C9A000027
v.	:	
	:	**HEARING PANEL DECISION**
LUTHER A. HANSON (CRD #1956960), Charleston, West Virginia	:	Hearing Officer - SW
	:	Dated: March 8, 2001
Respondent.	:	

Digest

The Department of Enforcement ("Enforcement") filed a one-count Complaint against Respondent Luther A. Hanson ("Respondent"), alleging that Respondent violated NASD Conduct Rules 3040 and 2110 by participating in the offer and sale of securities without prior written notice to, and approval of, his employer, Royal Alliance Associates, Inc. ("Royal Alliance"). Respondent admitted participating in the sale of certain promissory notes, but denied the violation, arguing that the promissory notes were not securities and that he provided oral notice of the sales to his firm.

The Hearing Panel held that the promissory notes were securities and that Respondent violated Rules 3040 and 2110 as alleged in the Complaint. The Hearing Panel suspended Respondent for 90 days, required him to re-qualify as a general securities representative within six months, and directed Respondent to disgorge his $79,105.62 in commissions to his

customers, in the manner set forth on Exhibit A, and provide proof of the payment to the NASDR staff no later than June 30, 2001.[1] The Hearing Panel also ordered Respondent to pay the $1,634.75 costs of the Hearing.

Appearances

Thomas K. Kilkenny, Esq. Regional Attorney, Philadelphia Pennsylvania, for the Department of Enforcement.

Michael W. Rice, Esq. Scott Depot, West Virginia for Respondent Luther A. Hanson.

DECISION

I. Procedural Background

On July 31, 2000, the NASD Regulation, Inc. Department of Enforcement ("Enforcement") filed its Complaint in this disciplinary proceeding, alleging that Respondent participated in the offer and sale of securities, when he offered and sold promissory notes issued by Capital Funding, Inc. ("Capital Funding") to 35 customers, without prior written notice to, and approval of, his firm, Royal Alliance, in violation of NASD Conduct Rules 3040 and 2110. Respondent admitted that he had offered and sold the Capital Funding promissory notes, but he argued the notes were not securities within the meaning of the securities laws.

The Hearing Panel conducted a Hearing in Washington, DC, on November 6, 2000.[2] In addition to the testimony of Respondent, Enforcement offered the testimony of Respondent's

[1] To the extent that Respondent provides proof, by June 30, 2001, that particular customers have recouped their investment either because they did not reinvest the funds or their legal actions against the issuer of the promissory notes are successful, the commissions relating to such customers should be converted to a fine to be paid to the NASD no later than July 15, 2001. See District Bus. Conduct Comm. for Dist. No. 3 v. Michael J. Dormanen Complaint No. C3A950011, 1996 NASD Discip. LEXIS 56, at *23 (November 18, 1996)(Restitution to customers converted to a fine under certain circumstances).

Royal Alliance supervisor, Robert Capito. The Hearing Panel also admitted the three exhibits that Enforcement offered as evidence. Respondent testified on his own behalf, but did not offer any separate exhibits. The Hearing Panel also admitted the two joint stipulations of facts, which the Parties submitted.[3]

II. Findings of Fact and Conclusions of Law

A. Jurisdiction

Respondent was registered from January 31, 1997 to May 17, 1999 as a general securities representative with Royal Alliance. (Stip at ¶5). Since May 14, 1999, Respondent has been registered with Medallion Equities, Inc. ("Medallion") as a general securities representative. (Stip at ¶7; CX-1, p. 2). Accordingly, the Hearing Panel determined that the Association has jurisdiction over Respondent.

B. Respondent Offered and Sold Securities Without Prior Written Notice to, and Approval of, Royal Alliance

The Parties have stipulated to most of the facts in this case. The only factual issue in dispute is whether Respondent provided oral notice of the sale of the promissory notes to Royal Alliance.

1. Background

Beginning in 1980, Respondent owned and operated L. A. Hanson Accounting Services ("Hanson Accounting"). (Stip. at ¶8). In addition, from 1990 onward, Respondent

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[2] "Tr." refers to the transcript of the Hearing held on November 6, 2000, and "CX" refers to Complainant's exhibits offered at the Hearing.

[3] Statements in the first Stipulation between Respondent and Enforcement are referred to as "Stip at ¶." The two paragraphs in the second Stipulation between Respondent and Enforcement are referred to as "Stip II at ¶."

was the majority owner and operator of the Estate Planning Group ("Estate Planning"). (Stip. at ¶9). Through Hanson Accounting and Estate Planning, Respondent performed accounting, tax consulting, trust, and estate planning services; sold insurance products; and conducted educational seminars for his clients. (Tr. p. 38; CX-5, pp. 5-7).

In 1989, Respondent first became registered with the NASD as an investment company variable contract products representative ("Series 6" representative). (Stip. at ¶1). On March 8, 1995, Respondent became registered as a Series 6 representative through Keogler, Morgan & Company. ("Keogler"). (Stip. at ¶4). Subsequently, on April 6, 1995, Respondent became registered as a general securities representative through Keogler. (Id.). As a result of Royal Alliance's acquisition of Keogler, Respondent's registration was transferred on January 31, 1997 from Keogler to Royal Alliance. (Stip. at ¶¶5-6).

In April 1998, Respondent was introduced to the Capital Funding note program and began selling Capital Funding promissory notes to his Estate Planning customers. (Tr. pp. 52-53). Subsequently, Capital Funding failed to honor the promissory notes, and the Capital Funding noteholders filed a lawsuit against the company.[4] (Tr. pp. 123-124).

2. The Capital Funding Promissory Notes

In 1998 and 1999, Respondent offered and sold promissory notes issued by Capital Funding through both Hanson Accounting and Estate Planning. (Stip. at ¶¶10-11). The notes were purchased by the 33 individuals or entities identified on Schedule A of the Complaint and

[4] The record contains no other information concerning the litigation, such as the names of the parties, the specific violations alleged, the amount of damages claimed, or the current status of the litigation.

the index of customer initials.[5] (Stip at ¶16). The notes were purchased in the amounts identified on Schedule A to the Complaint, totaling $2,636,854,[6] and on the dates specified on Schedule A to the Complaint, beginning in April 1998. (Stip. at ¶¶17-18). Respondent received a commission of 3% on the gross amount of each note. (Stip at ¶19). The commissions totaled $79,105.62. (Tr. pp. 89-90).

The Capital Funding notes were sold through a two-page brochure, and were not the subject of an effective registration statement with the Securities and Exchange Commission. (Stip. at ¶¶20-21). In the brochure, Capital Funding represented that it was in the business of buying insured corporate receivables[7] or U.S. government backed receivables from First Capital Services, Inc. ("First Capital").[8] (Attachment B to Stip). To obtain the funding to purchase the receivables from First Capital, Capital Funding issued the subject fixed-rate, six-month promissory notes in the minimum amount of $25,000. (Tr. 42). Capital Funding recruited independent agents, such as Respondent, to market the promissory notes. (Tr. p. 67).

[5] Exhibit A to the Complaint lists 35 individuals or entities by initials. Based on the attached customer index, two of the customers participated in two separate purchases of the notes and, therefore, were listed twice on Exhibit A to the Complaint.

[6] The $2,636,854 included $1,129,344 in reinvestments or rollovers. Accordingly, Respondent's customers had a total investment of $1,560,798 in the promissory notes. The total investment shown on Exhibit A to the Complaint differs from the $1,609,592.81 amount shown on the list of Capital Funding notes provided by Respondent. (CX-5, p. 9).

[7] The corporate receivables were supposedly insured by Continental Insurance Company. (Attachments A and B to Stip).

[8] First Capital advertised that it was in the business of financing insured corporate receivables and government backed receivables since 1992. (Attachment B to Stip). First Capital filed Form UCC-1 financing statements to establish first lien security interests in the receivables purchased. (Id.).

The stated interest rates on the promissory notes were 9.25%, 9.5% or 9.65%.[9] (Stip at ¶14). Capital Funding collateralized the notes by partially assigning its security interest in the purchased receivable to the holders of the notes.[10] (Attachment B to Stip; Tr. p. 43). A number of the investors exercised the option of rolling over the notes at the end of the six-month term. (Tr. p. 122).

Respondent estimated that Capital Funding raised approximately $30 million selling its promissory notes. (Tr. p. 68).

3. Capital Funding Notes are Securities

Having stipulated to the sale of the Capital Funding notes, Respondent argued that the Capital Funding notes were not securities because the notes were issued in transactions which did not warrant the protection of the securities laws and/or the notes met the nine month exemption of the securities laws because they met the definition of commercial paper.

Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act") includes in its definition of "security," "any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months."[11] While this language appears straightforward, the courts have completely replaced the literal language of both "any note" and the nine month exemption with a transactional analysis. Rather than including and excluding notes, as the statute does, on the basis of their maturity date, the courts have developed a test

[9] Agents were able to set the interest rate of a particular note within the 9.25% to 9.65% range by reducing the amount of commission they would receive on that particular note. (Tr. p. 73).

[10] Capital Funding filed Form UCC-1 statements to establish security interests in the receivables that it purchased from First Capital. (Attachment B to Stip).

[11] 15 U.S.C. '78c(a)(1).

which looks to the transaction in which the note is given to determine whether it is the type of transaction that Congress was attempting to protect with the securities laws. If the transaction in which the promissory note is issued falls within the general purposes of the securities laws, the instrument is deemed a protected "security" under the statute.

Respondent and Enforcement agreed that the proper transactional analysis for determining whether a Capital Funding note was a security was the family resemblance test articulated by the Supreme Court in Reves v. Ernst & Young, 494 U.S. 56 (1990). Under the Reves family resemblance test, every promissory note is presumed to be a security, as defined in Section 3(a)(10) of the Exchange Act. However, the presumption that a note is a security can be rebutted if the note bears a strong family resemblance to an item on the judicially crafted list of exceptions.

The list of exceptions are (i) notes delivered in consumer financings, (ii) notes secured by mortgages on homes, (iii) short-term notes secured by liens on small businesses or some of the small businesses' assets, (iv) notes evidencing 'character' loans from banks, (v) short-term notes secured by an assignment of accounts receivable, (vi) notes which simply formalize an open-account debt incurred in the ordinary course of business, and (vii) notes evidencing loans by commercial banks for current operations.[12]

The Court identified four factors that specified what the above exceptions had in common that made them non-securities. The Reves Court discussed the four factors as follows:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise

[12] Reves, 494 U.S. at 60.

> money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." (Citation omitted.) Second, we examine the "plan of distribution" of the instrument, SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943), to determine whether it is an instrument in which there is "common trading for speculation or investment," id. at 351. Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. (Citations omitted) Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[13]

If an instrument is not sufficiently similar to an item on the list based on the four factors, the decision whether another category should be added is made by examining the same four identified factors. The absence of any one of these factors does not automatically result in a determination that the note at issue is not a security. "Rather, a balancing of the four [factors] must be conducted in order to determine whether, on the whole, the note looks more like a security than not."[14]

Enforcement reviewed the above four factors and argued that, based on three of the four factors, motivations of the parties, the distribution plan, and the lack of another regulatory scheme that significantly reduced the risk of the notes, the Capital Funding notes did not fall within, nor bear sufficient resemblance to, the excluded categories to be added as a new category to the list of non-securities. (Tr. pp. 82-85).

[13] Id. at 66-67.

Respondent's counsel reviewed the same four factors and argued that, based on the motivations, the distribution plan, expectations of the purchasers, and the collateralization of the notes by the accounts receivables,[15] the Capital Funding notes were not securities. He argued, in the alternative, that the notes (i) resembled two of the excluded categories, the short-term notes secured by lien on a small business or some of its assets or the short-term notes secured by an assignment of accounts receivable; or (ii) bore a sufficient family resemblance to those categories that they should be added as a new category of excluded notes. (Tr. pp. 100, 103).

Based on the evidence and a review of the four Reves factors, the Hearing Panel finds that the Capital Funding notes do not bear a sufficient resemblance to any of the categories of excluded instruments[16] and do not sufficiently resemble the excluded instruments to warrant being added to the Reves list of non-securities.

First, as discussed above, if the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a security. There is no dispute that Capital Funding sold the notes to raise money to fund its business of purchasing

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[14] In re NBW Commercial Paper Litigation, 813 F. Supp. 7, 11 n.7 (D.D.C. 1992).

[15] Respondent argued with respect to the first factor that the primary motivation of Respondent's clients was preservation of principal not profit. (Tr. p. 104). With respect to the second factor, Respondent argued that unlike Reves, which involved more that 23,000 people, this was more of "a one-to-one, invitation only distribution plan." (Tr. pp. 104-105). Third, he argued that generally the public does not consider a note a security. (Tr. pp. 105-106). (Neither Party presented any evidence regarding the motivations of the 33 customers.) Finally, Respondent argued that the note was not without legal protection because it did have collateral. (Tr. pp. 106-107).

[16] These notes differed from traditional receivable programs in the scope of the information available to the purchasers. In traditional account receivable programs, participants generally engage in one-to-one negotiation with the borrower and can inspect all information public and non-public that is relevant and consequently are able to do their own credit analysis. Here, the purchasers were not in a position to approach the borrowers and conduct their own examination.

account receivables. (Attachment B to Stip). With respect to the purchasers' motives, the promotional literature issued by Capital Funding advertised the "High Yield" of the notes. (Id.). Respondent admitted that his customers were motivated in part by the rate of interest the notes were expected to generate. If the customers' primary concern was preservation of principal, as argued by Respondent, they would not have invested in the Capital Funding notes to gain a higher interest rate than that available on a certificate of deposit, which clearly provides for preservation of principal. Thus, the motivation factor weighs in favor of finding the Capital Funding notes to be securities.

Second, the plan of distribution involved common trading. Common trading is established where individuals, rather than sophisticated institutional investors, are the offerees of the notes in question.[17] In this case, the notes were not sold to a specified and sophisticated market motivated by the commercial purpose of operating a lending business; instead they were sold to 33 individuals who had $25,000 to invest.[18] (Tr. p. 46). Accordingly, the plan of distribution factor also weighs in favor of finding the Capital Funding notes to be securities.

Third, if the investing public has a reasonable expectation that the instrument is an investment, the instrument is likely to be a security. Respondent admitted promoting the transactions to his customers as a part of his estate planning services, i.e., an investment proposition. (Tr. pp. 49-50). The customers relied on Respondent to determine whether the promissory notes were suitable options for them. (Tr. pp. 44-45). The brochure stated

[17] Stobier v. Securities and Exchange Commission, 161 F.3d 745, 751 (D.C. Cir. 1998), cert. denied, 1999 U.S. LEXIS 2642, 119 S.Ct. 1464 (1999).

[18] The brochure also indicated that the notes qualified for pension and IRA investments. (Attachment B to Stip). Two of the notes were sold to family trusts. (Exhibit A to the Complaint).

"[c]ommon sense will tell you this investment is an ideal combination of handsome returns, rock-solid safety, and liquidity." (Attachment B to Stip; emphasis added). Moreover, there were no countervailing factors that would have led a reasonable person to question the characterization of the notes by Respondent or the brochure. Thus, the third factor weighs in favor of the finding of a security.

The fourth and final inquiry looks to the adequacy of a regulatory scheme other than the federal securities laws in reducing risk to the lender. Respondent argued that there was no need for the protection provided by the securities laws because of the protection provided by the insurance and the collateralization of the promissory notes. The insurance provided by Continental Insurance Company was for the underlying collateral and not for the actual notes issued by Capital Funding. (Tr. p. 108). In addition, a specific note was not collateralized by a specific accounts receivable; rather the accounts receivables supported Capital Funding's general obligation to repay the notes. (Id.). The Hearing Panel, therefore, found there was no regulatory scheme that significantly reduced the risk of the notes. The litigation to recover the customers' funds verifies the Hearing Panel's finding. (Tr. p. 123). Thus, the fourth factor weighs in favor of a finding of a security.

In Reves, the Supreme Court explicitly left open the question whether the presumption that every note is a security applies to short-term notes, i.e., notes with terms of less than nine months. However, a number of circuits have limited the nine-month note exemption to commercial paper as opposed to investment securities. "The mere fact that a note has a maturity of less than nine months does not take the case out of [the securities laws], unless the

note fits the general notion of 'commercial paper.'"[19] The courts have thus narrowed the Exchange Act exclusion from "any note . . . which has a maturity at the time of issuance of not exceeding nine months" to notes which qualify as "(1) prime quality negotiable commercial paper, and (2) of a type not ordinarily purchased by the general public."[20] Accordingly, the presumption that a note is a security also may apply to notes of less than nine months maturity that are not commercial paper.[21]

Respondent and Enforcement agreed that Section 3(a)(10)'s nine-month note exemption applies exclusively to commercial paper. Enforcement argued that because the Capital Funding notes were issued in denominations well under a million dollars and basically anybody who had $25,000 could buy them, the Capital Funding notes were not commercial paper.

Respondent argued that the Capital Funding notes met the definition of negotiable instruments, which is virtually synonymous with commercial paper under the Code of West Virginia, where Respondent and the individual purchasers were located.[22]

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[19] Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795, 800 (2d Cir.), cert. denied, 414 U.S. (1973; see also Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485, 1489 (10th Cir.), cert. denied, 498 U.S. 958 (1990); Baurer v. Planning Group, Inc., 215 App. D.C. 384, 669 F.2d 770, 776 (D.C. Cir. 1981); McClure v. First National Bank, 497 F.2d 490, 494-495 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975); Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075 (7th Cr. 1972), cert. denied, 409 U.S. 1009 (1972).

[20] Sanders, 463 F.2d at 1079.

[21] SEC v. R.G. Reynolds Enter., Inc. 952 F. 2d 1125, 1132 (9th Cir. 1991), 1991 U.S. App. LEXIS 30066, **17 (1991).

[22] In the West Virginia Code, a negotiable instrument is an unconditional promise to pay a fixed amount of money that is payable to bearer, or to the order of, at the time it is issued and does not state any other undertaking or instruction by the person promising the payment to do any act in addition to the payment. (Tr. p. 112).

Commercial paper for purposes of the exclusion from the coverage of the securities laws is defined as short-term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors.[23] By claiming the exemption, Respondent has the burden of persuasion that the Capital Funding notes meet both criteria of commercial paper, i.e., it is of prime quality and it is not generally available to the public. Respondent failed to meet this burden. Accordingly, the Hearing Panel agrees with Enforcement and finds that the Capital Funding promissory notes were not prime quality commercial paper within the meaning of Section 3(a)(10)'s nine-month exemption.

Accordingly, the Hearing Panel finds that Respondent failed to rebut the presumption that the Capital Funding notes are securities and failed to prove that the Capital Funding notes met the requirements of the exemption for commercial paper. The Hearing Panel, therefore, finds that the Capital Funding notes are securities.

4. Conclusion

Rule 3040 provides that "no person associated with an NASD member firm shall participate in any manner in a private securities transaction except in accordance with the requirements of this rule." Rule 3040 further requires that an associated person who intends to participate in a private securities transaction, prior to the transaction, must "provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's role therein and stating whether he has received or may receive selling

[23] See S. Rep. No. 47, 73rd Cong., 1st Sess, 3-4 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess., 15 (1993)(the legislative history of the Securities Act of 1933 indicates that the exemption was meant to apply to short term paper of a type which is rarely bought by private investors.) The Supreme Court has consistently held that the definitions of a security in the 1993 and 1934 Acts are virtually identical and the coverage of the acts my be considered the same. Reves, 494 at 61 n.1.

compensation in connection with the transaction . . . ." Further, if the transaction is for compensation, the member firm must approve or disapprove of the proposed transaction in writing.

Rule 3040 defines a "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission."

The record shows that Respondent participated in the private sale of securities, failed to provide Royal Alliance with prior written notice of the transactions, received approximately $80,000 in commissions for the private transactions, and failed to receive approval of Royal Alliance to participate in the transactions. Accordingly, the Hearing Officer finds that Respondent violated Rule 3040 as alleged in the Complaint. Respondent's violation of Rule 3040 was also a violation of Rule 2110's requirement to "observe high standards of commercial honor and just and equitable principles of trade."[24]

III. Sanction

Enforcement requested that Respondent be barred for violating Rule 3040, or, in the alternative, that Respondent receive a suspension and a fine of at least $80,000. The NASD Sanction Guidelines relating to a private securities transaction recommend a fine of $5,000 to $50,000, and provide that adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial benefit. The Sanction Guidelines recommend that the

[24] District Bus. Conduct Comm. for Dist. Number 8 v. Norman M. Merz, Complaint No. C8A960094 (NAC, November 20, 1998).

adjudicator consider suspending the respondent for up to two years, and, in egregious cases, consider barring the respondent.[25]

In determining what sanctions should be imposed, the Hearing Panel first considered the four specific considerations listed in the Guidelines. The four factors are (1) whether the respondent had a proprietary or beneficial interest in, or was otherwise affiliated with the issuer; (2) whether the respondent attempted to create the impression that the employer sanctioned the activity; (3) whether the selling away involved customers of the employer; and (4) whether the respondent provided the employer with verbal notice of all relevant factors of the transaction.[26]

The evidence established that Respondent did not have a proprietary or beneficial interest in, and was not otherwise affiliated with the issuer of the notes, Capital Funding, or with First Capital. Neither did Respondent attempt to create the impression that Royal Alliance sanctioned the actions.

However, the selling away did involve several customers of Royal Alliance.[27] Although Respondent made the Capital Funding brochure available to Royal Alliance, Respondent's actions did not provide Royal Alliance with verbal notice of all relevant factors of the transaction. (CX-14).

The Hearing Panel also considered certain of the general considerations listed in the Guidelines, which included: (1) Respondent engaged in the misconduct over an extended

[25] NASD Sanction Guidelines, p. 15 (1998).

[26] NASD Sanction Guidelines, p. 15 (1998).

[27] Respondent estimated that about 11 of the 33 customers were Royal Alliance customers at the time that they purchased the Capital Funding notes. (Tr. pp. 55-56).

period of time, approximately 13 months (Attachment B to Stip); (2) Respondent engaged in numerous acts of misconduct, approximately 60 separate transactions, when the rollover transactions are included (Id.); (3) the misconduct resulted in injury to the investing public (according to Respondent, at the time of the Hearing, only three of the customers had recouped their investments) (Tr. p. 123); and (4) Respondent's misconduct resulted in monetary gain to Respondent totaling $79,105.62 in commissions (Attachment B to Stip).[28]

However, Respondent's misconduct was not an intentional violation of the rule, nor did he attempt to conceal his misconduct, or deceive his customers or the regulatory authorities. Respondent testified that he did not believe the promissory notes were securities because they were short-term and because of Capital Funding's representations that the notes were not securities. The Hearing Panel believes that Respondent did not think the notes were securities requiring disclosure.[29] (Tr. p. 62).

The Hearing Panel was impressed by Respondent's candor. Although arguing that he had provided Robert Capito with oral notice of the Capital Funding notes because he made the Capital Funding brochure available to Mr. Capito during the April 1998 audit of his office, Respondent admits that Mr. Capito became distracted and did not get back to it.[30] (Tr. p. 49). Mr. Capito was given free access to Respondent's office including the files of Hanson Accounting and Estate Planning. (Tr. p. 53). Mr. Capito admitted that he did not review any

[28] NASD Sanction Guidelines, Principal Consideration Nos. 8-11, 17, pp. 8-9 (1998).

[29] As a matter of law, Respondent is presumed to know and understand the NASD Rules. Carter v. SEC, 726 F.2, 472, 474 (9th Cir. 1983).

[30] Respondent's immediate supervisor at Royal Alliance was Mr. Capito. (Stip at ¶23). During April 1998, Mr. Capito conducted an audit of Respondent's office on behalf of Royal Alliance.

information concerning the two companies during his audits, although the two companies operated out of the same office, and Respondent disclosed that the majority of his annual compensation, ranging from $100,000 to $120,000, was derived from those two entities. (Tr. p. 31; CX-3, pp. 4-5). If Royal Alliance had taken the opportunity to further discuss the activities of Hanson Accounting and Estate Planning, the Hearing Panel is certain Respondent would have fully discussed the Capital Funding note program with Mr. Capito.[31] Respondent testified that Royal Alliance was the first NASD member to conduct an on-site audit of his offices and he appeared grateful and pleased that Royal Alliance made a greater effort than his previous members to help his office be organized for compliance purposes. (Tr. p. 54). The Hearing Panel viewed Respondent's enthusiastic cooperation with the audit as another example of Respondent's good faith effort to comply with the NASD rules.

Subsequently, Respondent attempted to remedy the consequences of his misconduct by providing funds for a lawsuit against the issuer on behalf of his customers. (Tr. p. 123).

The Hearing Panel determined that several aggravating factors, which were present in other private securities cases in which bars were imposed, were not present in this case. Respondent had not intentionally misled his customers, had not omitted material information concerning his involvement with the issuer of the promissory notes, or falsely answered questions concerning the transactions on a routine compliance questionnaire.[32]

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[31] The outside business activity questionnaires that Respondent completed during the 1998 audit with the assistance of Mr. Capito had three blank lines for Respondent to describe the activities of Hanson Accounting and Estate Planning. (CX-5, pp. 6-7). The only securities question on the questionnaire was "Have you ever or do you intend to recommend investment in or the purchase or sale of securities of the entity identified [Hanson Accounting or Estate Planning]?"

[32] See, e.g., Charles E. French, Exchange Act Release No. 37409 (July 8, 1996), 1996 WL 378583 (1996); Stephen J. Gluckman, Exchange Act Release No. 41628 (1999), 1999 WL 507864 (July 20, 1999); and District

In addition, unlike the respondent in Newcomb[33] in which a two-year suspension was imposed, at no time prior to his termination did Respondent know, or suspect, that the promissory notes were securities and that he was engaging in private securities transactions. Royal Alliance stipulated that it had not published any letter, memorandum or other written warning to its agents specifically addressing promissory note programs. (Stip II at ¶2). Furthermore, unlike Newcomb, in which the member firm was misled by the respondent's inaccurate description of his activities in his notice to his member firm, the Hearing Panel did not find that Royal Alliance was misled by Respondent's questionnaires.[34] Moreover, the Hearing Panel believes that future violations by Respondent are unlikely, in part, because of his otherwise unblemished record in the industry, and because he has not repeated this misconduct since his move to Medallion.

On the other hand, the Hearing Panel is concerned that Respondent has demonstrated a lack of knowledge of one of the basic requirements for a brokerage business, i.e., that any question regarding a possible security should be raised with the NASD member firm. Consequently, the Hearing Panel believes that requalification is appropriate.

Taking all of the above factors into consideration, the Hearing Panel determined that Respondent's misconduct was serious, but that Respondent was not a danger to the investing public. Accordingly, the Hearing Panel suspended Respondent for 90 days, required him to re-

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Bus. Conduct Comm. for Dist. No. 5 v. John P. Goldsworthy, Complaint No. C05940077, 2000 NASD Discip., LEXIS 13 (October 16, 2000).

[33] Department of Enforcement v. Jim Newcomb, Complaint No. C3A990050, 200 NASD Discip. LEXIS 15 (November 16, 2000).

[34] Respondent's three-line description of the primary functions of Hanson Accounting and Estate Planning was accurate.

qualify as a general securities representative within six months, and directed Respondent to disgorge his $79,105.62 in commissions to his customers in the manner set forth on Exhibit A, and provide proof of the payment to the NASDR staff no later than June 30, 2001.[35] To the extent that Respondent provides proof that particular customers have recouped their investment by June 30, 2001, either because they did not reinvest the funds or because their lawsuits were or are successful, the commissions relating to such customers should be converted to a fine to be paid to the NASD no later than July 15, 2001.

IV. Conclusion

Based on the evidence, the Hearing Officer suspends Respondent for 90 days, requires him to re-qualify as a general securities representative within six months, and directs Respondent to disgorge his commissions to his customers in the manner set forth on Exhibit A, no later than June 30, 2001. To the extent that Respondent provides proof that particular customers have recouped their investment either because they did not reinvest the funds or the their lawsuits were or are successful by June 30, 2001, the commissions relating to such customers should be converted to a fine and paid to the NASD no later than July 15, 2001. Respondent is also ordered to pay the $1,634.75 Hearing cost, which includes an administrative fee of $750 and Hearing transcript costs of $884.75.

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

[35] Respondent stipulated that he received 3% commissions on the principal amount of the notes sold. Taking into account rollovers, Respondent earned commissions on $2,636,854 principal amount for total commissions of $79,105.62. See Department of Enforcement v. Michael A. Usher, Complaint No. C3A980069, 2000 NASD Discip. LEXIS 5 (April 18, 2000) (Disgorgement is appropriate when the direct financial gain obtained by a wrongdoer as a result of his or her wrongful actions can be identified.)

except that if this Decision becomes the final disciplinary action of the Association the suspension shall become effective with the opening of business on Monday, May 7, 2001 and end on August 5, 2001.[36]

SO ORDERED.

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Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
March 8, 2001

Copies to:
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[36] The Hearing Panel considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.