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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	
Complainant,	Disciplinary Proceeding No. CLI030013
v.	
Respondent 1	**Hearing Panel Decision**
	Hearing Officer - SW
Respondent 2	
and	
Respondent 3	
	Dated: August 6, 2004
Respondents.	

Enforcement failed to prove by a preponderance of the evidence that the Respondents violated Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5 thereunder, Section 17(a) of the Securities Act of 1933 through NASD Conduct Rule 2110, and NASD Conduct Rules 2120 and 2110. Accordingly, the Complaint is dismissed.

Appearances

Jon S. Batterman, Esq., Regional Counsel, Jericho, New York, and Philip A. Rothman, Esq., Regional Counsel, New York, New York, for the Department of Enforcement.

TF, Esq., New York, New York, for Respondents.

DECISION

I. Introduction

A. Complaint and Answer

On June 3, 2003, the Department of Enforcement ("Enforcement") filed a one count Complaint alleging that Respondent 1, acting through Respondent 2 and Respondent 3, (collectively the "Respondents"), engaged in fraud by soliciting customers to purchase securities of Huntington Laurel Partners, L.P. ("HLP"), a hedge fund formed by Respondent 2 and Respondent 3, without disclosing certain material facts concerning the use of proceeds of the offering. Specifically, the Complaint alleges that the Respondents failed to disclose that they: (i) engaged in a related-party transaction with HLP; and (ii) invested a majority of the HLP proceeds in a one-year term loan.

The Respondents denied that they had omitted material information from the original confidential private placement memorandum ("PPM") and requested a hearing.

B. Hearing

The Parties presented evidence to a Hearing Panel in New York, NY.[1] The Hearing Panel consisted of one member of the District 10 Committee, one member of

[1] References to the testimony set forth in the transcript of the Hearing on December 17 and 18, 2003 will be designated as "Tr. p.," with the appropriate page number. References to the exhibits provided by Enforcement will be designated as "CX-," and references to the exhibits provided by the Respondents will be designated as "RX-."

the District 9 Committee, and the Hearing Officer. The Hearing Panel finds that Enforcement failed to meet its burden of showing by a preponderance of the evidence that the Respondents committed fraud or made negligent material omissions. Accordingly, the Hearing Panel dismisses the Complaint.

II. Discussion

A. Jurisdiction

When Enforcement filed the Complaint on June 3, 2003, Respondent 1 was a member of NASD and Respondent 2 and Respondent 3 were registered with NASD. Thus, NASD has jurisdiction over the Respondents.

B. Findings of Fact and Conclusions of Law

1. The Respondents

a. Respondent 1

Respondent 1 was founded by Respondents as an NASD member in approximately 1993. (Tr. pp. 401, 403). On September 10, 2003, Respondent 1 filed a BDW form to withdraw from NASD membership. (CX-1, p. 2).

b. Respondent 3

In 1975, Respondent 3 became initially registered with NASD as a general securities principal with Deutsche IXE, LLC.[2] (CX-3, pp. 11-12). On June 8, 1999, Respondent 3 became registered as a general representative with Respondent 1. (CX-3, p. 10). Subsequently, Respondent 3 was registered as an equity trader and general securities principal with Respondent 1 on October 20, 1999 and January 2, 2000,

[2] Respondent 3 had been employed by Deutsche IXE, LLC seven years before he became a registered representative. (CX-3, p. 11).

respectively. (CX-3, p. 10). Respondent 3 is not currently associated with an NASD member. (Id.).

c. Respondent 2

In 1984, Respondent 2 initially became registered with NASD through J. Gregory & Company, Inc.[3] (CX-2, pp. 5, 8). From March 30, 1995 until August 28, 2003, Respondent 2 was registered with Respondent 1 as general securities principal, general securities representative, and an options principal. (CX-2, p. 5). Respondent 2 is not currently associated with an NASD member. (Id.).

2. HLP Offering

During the relevant period in 2002, Respondent 2 was the chairman and owned approximately 20% of Respondent 1. (Tr. p. 243). Respondent 3 was the president and owned approximately 20% of Respondent 1. (Id.). Respondent 1's primary business was proprietary trading, and Respondent 1's secondary line of business involved equity offerings, i.e., private placements. (Tr. p. 244).

In 2002, RS, an entrepreneur and North Carolina registered representative with Metropolitan Life Insurance Company ("Met Life"), was a customer of Respondent 1 and had known Respondent 2 and Respondent 3 for about five years. (Tr. pp. 104, 107, 116). In March 2002, Met Life directed RS to "unwind" two of his outside investment funds, limited partnerships known as Premier I and Premier II. (Tr. pp. 109-110, 113). RS needed to raise approximately \$2 million to \$2.5 million to redeem the promissory notes of the Premier I and II investors. (Tr. pp. 125, 186). RS agreed with Met Life to complete the unwinding of Premier II by December 31, 2002, and the unwinding of

Premier I by June 30, 2003. (Tr. p. 111). RS considered and investigated a number of avenues to raise the necessary funds. (Tr. pp. 115-116, 126).

In March 2002, RS approached Respondent 1 to assist him in raising money from certain of his private business assets. (Tr. p. 115). On March 20, 2002, RS entered into an investment banking agreement with Respondent 1, which provided that Respondent 1 would provide certain investment services to RS in exchange for a $100,000 fee. (Tr. pp. 249-250; CX-18). The investment services included providing advice concerning potential mergers, acquisitions, financings, and valuing the assets for sale. (Id.). RS did not tell the Respondents the total amount of cash that he needed to raise. (Tr. p. 250).

During 2002, the Respondents had been contemplating setting up a hedge fund to raise money to take advantage of what they perceived to be the next bull market. (Tr. pp. 259, 415). On May 23, 2002, HLP executed a 10-year limited partnership agreement with Huntington Laurel Capital Management, LLC, as the general partner. (CX-6, pp. 104, 110). Respondents were the sole partners of the general partner. (CX-6, pp. 104-120).

The Respondents intended that HLP would provide them with the widest possible investment discretion. (Tr. pp. 310-311). To that end, in raising funds for HLP, the Respondents utilized a June 2002 PPM that provided that HLP intended to achieve a goal of long-term capital appreciation by investing opportunistically in a broad range of investments ("Portfolio Investments"). (CX-6, p. 84). The range of investments listed in the PPM included:

[3] In March 1990, when Respondent 2 terminated his registration with J. Gregory & Company, Inc., the

> investments in equity, debt, options and other securities of public and private companies, trading equity, debt, options and other securities in the public markets (including the use of short sales, margin and future contracts), purchasing and selling mortgages and ownership interests in real estate, including but not limited to income producing residential properties, retail properties, commercial properties, industrial warehouse properties and hotels. (Id.).

The PPM also explicitly disclosed that HLP's Portfolio Investments "may not necessarily be diversified." (CX-6, p. 88).

The PPM also disclosed the potential for related party transactions under a section entitled "Conflicts of Interest." (Id.). The PPM disclosed that:

> [the Respondents] are affiliates . . . of several other financial and investment related entities. Those entities may invest in, be party to, or otherwise have an interest in [HLP], its Portfolio Investments, and the transactions pursuant to which [HLP] may make such Portfolio Investments, including, but not limited to, acting as placement agent or advisor to the entities in which [HLP] may invest. Additionally, the General Partner, [the Respondents] and their affiliates may receive a commission for assisting [HLP] raise capital, may receive a finder's fee for investments made by [HLP], may invest in the same investments as [HLP] (on the same or better terms as [HLP])." (Id.).

The possibility of related-party transactions was discussed in three separate places in the PPM. (CX-6, pp. 81, 88, 93).

In June 2002, after conducting an extensive review of certain of RS's assets, Respondent 1 recommended that RS not sell his assets at the time because, in the Respondents' view, RS would not be able to obtain the full value of his assets based on the then-current market. (Tr. pp. 118, 254). Because of Respondent 1's advice that he not sell, RS asked Respondent 1 to arrange for a $500,000 loan. (Tr. pp. 217-218). Respondents ultimately agreed to lend RS $300,000. (Tr. p. 218). There is no evidence,

name of Respondent 1 was Respondent 2 & Co., Inc. (CX-2, p. 8).

and Enforcement does not suggest, that Respondents discussed or contemplated making a loan to RS before the end of June 2002. (Tr. pp. 282-283).

On June 28, 2002, RS executed a $300,000 loan agreement with Cyndel & Co. Inc. ("Cyndel"), a Delaware company formed in 1992, which was 50% owned by Respondent 3 and 50% owned by Respondent 2. (CX-4; Tr. p. 247). RS pledged certain assets to secure a six-month loan that was to mature on December 31, 2002.[4] (CX-4). The collateral pledged by RS was valued at between $4 million and $5 million. (Tr. p. 324). At the time the Respondents made the Cyndel loan, neither Respondent 3 nor Respondent 2 discussed, contemplated, or had any intent to make any additional loans to RS. (Tr. pp. 258-259, 414).

In June and July 2002, the Respondents began soliciting investors for HLP, using the PPM, which they had prepared with the assistance of their securities counsel. During June and July, neither Respondent 2 nor Respondent 3 planned to sell the Cyndel loan to HLP. (Tr. p. 265).

On July 3, 2002, HLP received its first investment from Mr. SJ. (CX-12). By the end of August 2002, HLP had raised $595,000 from eight investors, including Cyndel, which invested $100,000 in HLP. (CX-12). In August 2002, NASD began a cycle examination of Respondent 1, which continued into November 2002, December 2002, and January 2003, because of Respondent 1's involvement with the HLP offering. (Tr. pp. 33-34).

[4] RS is listed as the borrower in the agreement. (Tr. pp. 230-231). The assets consisted of: (i) RS's 19% interest in the Premier Alliance Group, Inc.; (ii) RS's 31% interest in Sharon Road Properties, LLC; and (iii) RS's 6.9% interest in Carolina Beer & Beverage, LLC. (CX-4, pp. 14-15). The loan was also secured by a subordinated mortgage on RS's personal residence. (CX-4, p. 15). The loan included a $10,000 fee. (Tr. p. 122).

In the fall of 2002, Respondent 2 and Respondent 3 were "negative on the market" and decided to leave the money raised in the HLP offering in a J.P. Morgan private banking account. (Tr. p. 422). For the month of September 2002, J.P. Morgan's private banking money market fund paid a yield of 1.47%. (CX-13, p. 140).

In September 2002, the Respondents viewed the $300,000 Cyndel loan as a collateralized, performing short-term loan with a good yield as compared to the then-current market yields and the yields on money market funds. (Tr. p. 273-274). According to Respondent 2, the 10% interest bearing Cyndel loan had virtually no downside because the collateral for the loan was worth considerably more than the amount of the loan. (Tr. pp. 258, 414).

In September 2002, the Respondents considered transferring the Cyndel loan to HLP to provide their HLP investors with a higher return on their investment. (Tr. pp. 274, 422). On September 4, 2002, Respondent 2 spoke with his attorney, who had drafted the PPM and the underlying partnership agreement. (Tr. pp. 352, 370). The attorney confirmed that the Respondents could assign a loan from a related party to HLP. (Tr. pp. 352, 366, 370). On September 13, 2002, Respondents assigned Cyndel's $300,000 RS loan to HLP.[5] (Tr. p. 273; CX-7).

After the Respondents assigned the $300,000 Cyndel loan to HLP, four individuals invested an additional $340,000 in HLP from September 18 to September 20, 2002. (CX-12). Messrs. JS and HJ were the only two new investors; Messrs. JK and TK had previously invested in HLP and simply increased the size of their investment.

[5] HLP issued a check for $300,000 dated September 12, 2002 to Cyndel. (CX-8).

(Tr. p. 74; CX-12). All of the investors were former customers and friends of the Respondents. (Tr. pp. 266, 334, 418-421).

Because of the ongoing NASD investigation, the Respondents ceased soliciting funds for HLP in late September 2000 and turned away investors. (Tr. pp. 272, 341). After the investment of the four individuals who invested in HLP in September 2002, HLP did not solicit any new investors. (CX-12; Tr. pp. 74, 266). Later, Respondent 3 invested an additional $100,000 in HLP. (Id.)

In late September 2002, RS renewed discussions with the Respondents regarding the possibility of selling his assets, specifically the Sharon Road Properties, to the Respondents or an affiliated entity. (Tr. pp. 162-163, 277-278, 334-335; CX-19). The Parties did not reach an agreement, and subsequently, RS asked the Respondents for an additional loan. (Tr. pp. 172-174, 291).

On or about October 1, 2002, RS began negotiating a second loan with the Respondents for $400,000. (Tr. p. 126). On October 18, 2002, RS signed a $700,000 loan agreement with HLP, which incorporated the original $300,000 loan and added a $400,000 loan ("RS loan").[6] (RX-10). The RS loan was similar to the Cyndel loan in that it was over-collateralized and paid interest of 10%.[7] (Id.). Although the RS loan had a one-year term, the loan permitted RS to prepay the loan without penalty, and RS advised the Respondents that he intended to "pay it off early." (Tr. p. 166). On June 10, 2003, RS obtained an equity line of credit on his home at a 4% interest rate, and paid off the $700,000 loan. (CX-17, p. 166; Tr. pp. 166-167).

[6] RS executed an amended and restated secured $700,000 promissory note for the RS loan. (CX-10).

[7] The RS loan had the same collateral as the Cyndel loan, valued at between $4 million and $5 million. (CX-10; Tr. p. 324).

No investors complained to NASD or the Respondents about the HLP offering. (Tr. p. 68). The Respondents received no investor complaints regarding either the $300,000 assignment of the Cyndel loan or the issuance of the $700,000 RS loan, and no investor lost any money in the HLP investment. (Tr. pp. 299, 431). The Respondents disclosed that $700,000 of the proceeds of the HLP offering were invested in a loan in HLP's 2002 year-end financial statements, which statements were made available to the HLP investors.[8] (Tr. p. 298; CX-16, pp. 160, 163-164).

3. No Material Omissions

The one-count Complaint alleges that the Respondents, from July 2002 through September 2002, in connection with the inducement or attempt to induce the purchase or sale of a security or with the offer, sale and purchase of a security, failed to disclose in the PPM, or in a supplement or sticker to the PPM, the assignment of the $300,000 loan from Cyndel to HLP, or that $700,000 of the funds raised through the offering were used to provide a loan to RS. The Complaint alleges that these omissions were material and violated Section 17(a) of the Securities Act of 1933 ("Securities Act") through NASD Conduct Rule 2110, Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.

Enforcement argued: (i) that the Respondents omitted to disclose the material facts fraudulently, i.e., with scienter, in violation of Section 17(a)(1) of the Securities Act through NASD Conduct Rule 2110, Section 10(b) of the Exchange Act and SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110; or in the alternative (ii) the Respondents negligently omitted the disclosures, in violation of Sections

[8] The accountant's review report on the December 31, 2002 financial statements is dated March 24, 2003.

17(a)(2) and 17(a)(3) of the Securities Act through NASD Conduct Rule 2110, and NASD Conduct Rule 2110 independently.

Enforcement also argued that, as soon as the investment in the RS loan occurred, the Respondents had a duty to disclose the RS loan as supplemental information to the original investors immediately rather than as part of the periodic disclosure obligations set forth in HLP's limited partnership agreement.

a. Fraud Not Proven

(i) Anti-Fraud Provisions

All of the anti-fraud provisions prohibit essentially the same type of conduct. Section 17(a) of the Securities Act proscribes fraudulent conduct in the offer or sale of securities, while Section 10(b) of the Exchange Act[9] and Rule 10b-5 proscribe fraudulent conduct in connection with the purchase or sale of securities. NASD Conduct Rule 2120, the NASD's anti-fraud rule provides, "No member shall effect any transaction in,

or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."[10] It is well settled that any conduct that violates the securities laws and regulations or NASD rules also violates NASD Conduct Rule 2110.[11]

(CX-16, p. 159).

[9] Section 10(b) of the Exchange Act provides, "It [is] unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[10] See also DBBC v. Euripides, 1997 NASD Discip. LEXIS 45, at *18 (NBCC, July 28, 1997).

[11] See Ramiro Jose Sugranes, Exchange Act Rel. No. 35,311, 1995 SEC LEXIS 234, at **3-4 (Feb. 1, 1995). See also Stephen J. Gluckman, 1999 SEC LEXIS 1395, at *22 (July 20, 1999) (finding that a

To prevail under Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, SEC Rule 10b-5[12] thereunder, and NASD Conduct Rule 2120, Enforcement had to prove that the Respondents:[13] (1) omitted to state a material fact that was necessary in order to make the other statements made in the PPM, in light of the circumstances under which they were made, not misleading; (2) in connection with the offer, sale, or purchase of securities; (3) with scienter.[14]

Liability for an omission arises only if, under the circumstances, failure to disclose a fact is misleading, and the fact is material. "To be actionable, of course, a statement must also be misleading. Silence, absent a duty to disclose, is not misleading under Rule 10b-5."[15] A duty to disclose occurs when, in light of the statements made and the surrounding circumstances, disclosure of particular facts is necessary to avoid misleading impressions.[16] The duty encompasses <u>facts</u>, which may include present intent, opinion or expectations.[17] Further, the facts must be material, which means that there is a substantial likelihood that a reasonable investor would consider them important in making an investment decision and would view disclosure of them as

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violation of Rule 10b-5 or NASD Conduct Rule 2120, constitutes a violation of NASD Conduct Rule 2110).

[12] SEC Rule 10b-5 provides, "It [is] unlawful for any person . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading . . . ."

[13] Unlike a private litigant, NASD need not show justifiable reliance upon the alleged misrepresentation, omission or fraudulent device, nor damages resulting from such reliance. <u>See</u> <u>DBCC v. Coastline Financial, Inc.</u>, 1997 NASD Discip. LEXIS 9 (Mar. 5, 1997).

[14] <u>See</u> <u>Ernst & Ernst v. Hochfelder</u>, 425 U.S. 185, 193 n. 12 (1976). There is also a jurisdictional requirement for the federal anti-fraud provisions, which is interpreted broadly, and is satisfied by intrastate telephone calls and even the most ancillary mailings. <u>See</u> <u>SEC v. Softpoint, Inc.</u>, 958 F. Supp. 846, 865 (S.D.N.Y. 1997), <u>aff'd</u>, 159 F.3d 1348 (2d Cir. 1998).

[15] <u>Basic Inc. v. Levinson</u>, 485 U.S. 224, 239 n. 17 (1988).

[16] The antifraud provisions "prohibit only misleading and untrue statements, not statements that are incomplete." <u>Brody v. Transitional Hospitals Corp.</u>, 280 F.3d 997, 1006 (9th Cir. 2002).

significantly altering the total mix of information made available.[18] Applying these standards, the Hearing Panel finds that Enforcement failed to prove that the Respondents violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, or NASD Conduct Rule 2120.

(ii) Assignment of Cyndel Loan: Not a Material Omission

Enforcement argued that the Respondents' failure to disclose the assignment of the Cyndel loan was fraudulent because it was a related party transaction, citing Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982), and SEC v. Alliance Leasing Corporation, 2000 U.S. Dist. LEXIS 5227 (Mar. 17, 2000).

Those cases are inapposite. Although both cases involved failures to disclose related-party transactions, the circumstances differed significantly from those in this case. In Loftsgaarden, the defendant raised funds for a motel project through an offering statement that included a number of misrepresentations and omitted to disclose his present intention to utilize his closely-held corporations in the development of the project. As a result, the offering memorandum substantially understated the compensation the defendant expected to receive. In Alliance, in the materials used to promote the sale of the equipment leasing investment program, the defendants: (i) represented that they had selected supposedly "safe" companies to participate in the equipment leasing agreements, but failed to disclose that a majority of the companies were not at arm's-length; (ii) represented that the investment was low risk and guaranteed a high rate of return, but failed to disclose that they were paying 30%

[17] See, e.g., Basic Inc. v. Levinson, 485 U.S. at 231-32.

[18] Basic Inc. v. Levinson, 485 U.S. at 231-32; TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

commissions on the sales; and (iii) represented that they had a record of business integrity and experience, but failed to disclose that they had a prior bankruptcy, and that they had been the subjects of state cease and desist orders for fraudulent sale of unregistered securities. In each case, the information omitted was necessary to make the statements made in the offering memoranda not misleading.

As explained above, the facts in this case are entirely different. The Hearing Panel credits the Respondents' testimony that they had not determined to assign the Cyndel loan to HLP while they were soliciting investors with the PPM in June, July, and August 2002, and there is no evidence to the contrary. Accordingly, with respect to the majority of the investors, i.e., those who invested in HLP before September 2002, the Respondents did not misrepresent or fail to disclose their present intentions.

With respect to the Respondents' solicitations of investors in September 2002, Enforcement failed to prove that the Respondents' omission that the loan was initially held by Cyndel was misleading, or that it was material. The offering memorandum disclosed that the Respondents would have broad discretion in making investment decisions, and that their investments might involve related parties. Although the Respondents assigned the loan to HLP from Cyndel, a related party, the loan itself was not with a related party, was overly collateralized, had only three months remaining in its term, and had already performed for three months. The Respondents viewed the loan as the equivalent of a certificate of deposit, and there is nothing in the record to show that their assessment was incorrect. Under these circumstances, the Hearing Panel finds that the Respondents' failure to disclose the assignment of the loan from Cyndel was not a misleading material omission.

In addition, the Hearing Panel finds no evidence of scienter. Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud."[19] Scienter may be established by a showing of recklessness: "[A] highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[20]

The Hearing Panel finds no evidence, either direct or circumstantial, that the Respondents intended to deceive investors, or that, under the circumstances, the Respondents' failure to disclose the assignment of the loan was an extreme departure from the standards of ordinary care and presented a known or obvious danger of misleading investors.

The Hearing Panel concludes that the Respondents did not violate 17(a)(1) of the Securities Act through NASD Conduct Rule 2110, Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, or NASD Conduct Rules 2120 and 2110, by failing to update the PPM to disclose the assignment of the Cyndel loan to the HLP investors.

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[19] Hochfelder, 425 U.S. at 193 n. 12.

[20] David Disner, 52 SEC 1217, 1222 n. 20 (1997) (citing Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc)).

(iii) $700,000 RS Loan: Not a Material Omission

Enforcement argued that by investing $700,000 of the $935,000 raised in the HLP offering in the RS loan, the Respondents changed HLP's stated business strategy of achieving long-term capital appreciation by investing in equity investments. Accordingly, Enforcement contends that the Respondents fraudulently and materially increased the risk of the HLP investment.

Enforcement cited In re DWS Securities Corporation, 1993 SEC LEXIS 3137 (Nov. 12, 1993), and DBCC v. Brian Prendergast, 1999 NASD Discip. LEXIS 18 (Jul. 8, 1999), in support of its theory. However, in these cases, the defendants or the respondent used the proceeds of the offering in direct conflict with the terms of the offering circular.

In DWS Securities, the respondents used an offering circular that informed the investors that the proceeds would be used to acquire one or more entertainment companies as well as pay certain expenses of the new company. The offering circular also provided that, to the extent that the proceeds were not used immediately for those purposes, the proceeds would be invested in certificates of deposit or short term obligations of the United States. The proceeds were actually promptly transferred to accounts belonging to other entities and were used to pay the respondents' personal expenses and expenses of other entities controlled by the respondents. Noting that "[t]hese expenditures started immediately after the offering began and continued throughout the offering," the SEC found that, in light of the offering statement's representations regarding the intended uses of the proceeds, the respondents had an obligation to disclose the true uses, and that their failure to do so was fraudulent.

In Prendergast, the private placement memorandum stated that the proceeds would be invested 60% in S&P Stock Index futures and 40% in load and no-load mutual funds. However, approximately 59% percent of the proceeds were deposited in commodities accounts, approximately 4% were invested in low-price Canadian securities, and none of the funds were invested in mutual funds. Although the memorandum also included some language giving the respondent broad investment discretion, the NAC concluded that they did not "supercede the specific representations made in the PPM regarding the allocation of funds raised in the offering."

In this case, the RS loan was fully consistent with the representations in the HLP offering. The offering gave the Respondents broad discretion, and did not commit them to any particular type of investment. Further, the RS loan did not reflect abandonment of the overall purposes expressed in the PPM. Instead, it was a conservative, well-secured, short-term investment with an attractive rate of return that the Respondents elected to use while awaiting a better time to move into equities. The loan was repaid even before it was due, and the HLP investors benefited handsomely from the investment. The RS loan did not resemble in any respect the misuses of proceeds addressed in either DWS Securities or Prendergast.[21]

The Hearing Panel concludes that the Respondents did not violate Section 17(a)(1) of the Securities Act through NASD Conduct Rule 2110, Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, or NASD Conduct Rules 2120 and 2110, by

[21] Moreover, the Respondents did not make or contemplate the RS loan until after the solicitation of investors had effectively ended. The RS loan was not discussed until late September 2002 and did not occur until October 18, 2002, which was after the last non-affiliated investor invested in HLP on September 20, 2002.

failing to update the PPM to disclose the RS loan.

b. Negligence Not Proven

No scienter requirement exists for violations of Sections 17(a)(2) or 17(a)(3) of the Securities Act; negligence alone is sufficient.[22] Section 17(a)(2) of the Securities Act prohibits a person, in the offer or sale of any securities, from obtaining money by means of an untrue statement of a material fact or any misleading omission of a material fact. Section 17(a)(3) prohibits a person, in the offer or sale of any securities, from engaging in any transaction, practice or course of business that operates or would operate as a fraud or deceit upon the purchaser. Similarly, NASD Conduct Rule 2110 prohibits NASD members and associated persons from employing misleading omissions of material facts in the solicitation of investors.[23]

As discussed above, the Hearing Panel finds that the Respondents' failure to disclose the assignment of the $300,000 Cyndel loan to HLP was not a misleading material omission. In addition, as discussed above, the Hearing Panel finds that the Respondents' failure to disclose the $700,000 RS loan was not misleading or material, and was not a "fact" at the time that the Respondents were soliciting investors.[24] Accordingly, the Hearing Panel does not find that the Respondents violated Sections 17(a)(2) and (3) of the Securities Act through NASD Conduct Rule 2110, or NASD Conduct Rule 2110.

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[22] Meadows v. SEC, 119 F.3d 1219, 1226 n. 15 (5th Cir. 1997).

[23] See DBCC v. Euripedes, 1997 NASD Discip. LEXIS 45, at *18 (NBCC, Jul. 28, 1999).

[24] The Hearing Panel notes that Enforcement presented no investor witness to testify that the Cyndel loan or the RS loan was material information to that investor.

III. Conclusion

The Hearing Panel concludes that Enforcement has not established by a preponderance of the evidence that Respondents violated Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, Section 17(a) of the Securities Act through NASD Conduct Rule 2110, and NASD Conduct Rules 2120 and 2110. Accordingly, the Complaint in this proceeding is dismissed in its entirety.[25]

HEARING PANEL

____
Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
August 6, 2004

[25] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.