

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

L.H. ROSS & COMPANY, INC.
(BD No. 37920)

Respondent.

Disciplinary Proceeding
No. CAF040056

Hearing Officer – DRP

PANEL DECISION

January 14, 2005

Respondent L.H. Ross & Company, Inc. is fined \$500,000 and expelled from NASD membership for violating:

- (1) NASD Conduct Rule 2110 and Section 5 of the Securities Act of 1933, by participating in public offerings and sales of unregistered securities issued by L.H. Ross & Company, Inc. through a private placement offering in 2003; and**
- (2) Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, by making material misrepresentations and omissions of fact in connection with the offer, sale or purchase of securities issued by L.H. Ross & Company, Inc. through private placement offerings in 2003 and 2004.**

For these violations, Respondent is also ordered to pay restitution in the amount of \$11,011,008, plus prejudgment interest of at least \$450,113.87. A permanent cease and desist order is imposed.

Respondent L.H. Ross & Company, Inc. is expelled for violating NASD Procedural Rule 8210 and NASD Conduct Rule 2110, by failing to respond to requests for documents and information related to public offerings and sales of unregistered securities issued by L.H. Ross & Company, Inc. through private placement offerings in 2002, 2003 and 2004.

In view of the expulsions, Respondent is not further sanctioned for violating NASD Conduct Rule 2110, by placing unauthorized transactions in at least one customer account involving securities issued by L.H. Ross & Company, Inc. through a private placement offering in 2003.

Respondent is ordered to pay hearing costs of \$18,253.74.

Appearances

Gary M. Lisker, Roger D. Hogoboom and Brian D. Craig (Rory C. Flynn, Of Counsel) for the Department of Enforcement.

Gary Langan Goodenow, Goodenow Law Firm, P.A. and William Nortman, Akerman, Senterfitt for L.H. Ross & Company, Inc.

DECISION

I. Procedural History

On July 23, 2004, Enforcement filed a four-count Complaint alleging that L.H. Ross & Company, Inc. (LH Ross or Respondent) raised millions of dollars in 2003 and 2004 through the sale of unregistered private placement offerings of convertible preferred stock in LH Ross, employing fraudulent and illegal sales practices in soliciting customers, and in some instances, placed unauthorized purchases of LH Ross preferred stock into customers' accounts.

Enforcement also charged that Respondent failed to respond to NASD requests for documents and information related to the private placement self-offerings.¹

On July 23, 2004, Enforcement also filed a Notice initiating a temporary cease and desist proceeding against LH Ross pursuant to NASD Procedural Rule 9810. A hearing on the request

¹ Cause one charges that Respondent violated NASD Conduct Rule 2110 by virtue of violating Section 5 of the Securities Act of 1933, for participating in public offerings and sales of unregistered securities in connection with the 2003 private placement self-offering. Cause two charges that Respondent, through its registered representatives, violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and NASD Rules 2120 and 2110, by making material misrepresentations or omissions of fact in connection with the purchase, offer or sale of securities issued by LH Ross in the 2003 and 2004 private placement self-offerings. Cause three charges that Respondent violated NASD Conduct Rule 2110 by placing unauthorized transactions in customer accounts involving purchases of securities issued by LH Ross in the 2003 and 2004 private placements. Cause four charges that Respondent violated NASD Procedural Rule 8210 and NASD Conduct Rule 2110 by failing to comply with requests for documents and information.

for a temporary cease and desist order (TCDO) was held on August 9-11, 2004, before this Hearing Panel.²

On August 30, 2004, the Panel imposed a TCDO on LH Ross, pursuant to NASD Procedural Rule 9840. The Panel found by a preponderance of the evidence that LH Ross, through its registered representatives, made material misrepresentations and omissions of fact in connection with the offer, sale or purchase of securities issued by LH Ross in private placement self-offerings in 2003 and 2004, in violation of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, Section 17(a) of the Securities Act of 1933, and NASD Conduct Rules 2120 and 2110. In addition, the Panel found by a preponderance of the evidence that LH Ross had placed unauthorized transactions involving securities issued by LH Ross in at least one customer account, in violation of NASD Conduct Rule 2110. Finally, the Panel held that the firm's violative conduct or continuation thereof was likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of this disciplinary proceeding.

Accordingly, the Panel ordered Respondent to cease and desist offering or selling any securities issued by LH Ross and to cease and desist placing unauthorized transactions in customer accounts of securities issued by LH Ross. The Panel also ordered Respondent to cease and desist dissipating or converting customers' assets or causing other harm to investors and described in detail certain acts that Respondent was required to take or refrain from taking based on evidence regarding Respondent's apparent misuse of proceeds obtained from the private placement self-offerings.

² NASD's authority to impose and enforce temporary cease and desist orders provides a mechanism to curtail certain types of serious misconduct quickly, while formal disciplinary action is pending. *See* NASD Rule 9810 *et seq.* and Notice to Members 03-35 (June 2003).

Respondent filed an Answer to the underlying Complaint on September 9, 2004, and its motion to file an Amended Answer was granted on September 15, 2004.³ At the initial pre-hearing conference, the Hearing Officer ruled that evidence received during the TCDO proceeding was part of the record and need not be repeated at the disciplinary proceeding.⁴

On October 18-20, 2004, a three-day hearing was held in Boca Raton before the Panel. At the commencement of the hearing, Respondent stipulated that it violated NASD Conduct Rule 2110 by virtue of violating Section 5 of the Securities Act of 1933, for participating in public offerings and sales of unregistered securities in connection with the 2003 private placement self-offering, as charged in the first cause of the Complaint. Consequently, Enforcement moved for summary disposition of that charge pursuant to NASD Procedural Rule 9264. The Hearing Panel granted the motion, which Respondent did not oppose, because there was no genuine issue of material fact, and Enforcement was entitled to summary disposition as a matter of law.

Enforcement called three witnesses: NASD investigator Charlene GooD y and customers RO and WT. Enforcement also introduced 167 exhibits in evidence. Respondent called Franklyn Michelin, CEO and President of LH Ross, and introduced 12 exhibits in evidence.⁵

³ Prior to the hearing, Enforcement sought summary disposition of various affirmative defenses asserted by LH Ross in its Amended Answer. The Hearing Officer treated the application as a motion to strike and deferred ruling on the motion until after the hearing. The evidentiary record does not support Respondent's affirmative defenses. Accordingly, Enforcement's motion is granted. The Panel will discuss in greater detail defenses related to Respondent's liability for material misstatements and omissions of material fact by LH Ross brokers. *See* pp. 15-18, *infra*.

⁴ This ruling was guided by the federal rules of civil procedure, which provide in a similar context that "evidence received upon an application for a preliminary injunction which would be admissible upon the trial on the merits becomes part of the record on the trial and need not be repeated upon the trial." Fed. R. Civ. Pro. 65(a)(2).

⁵ References to the hearing transcript are noted as Tr. Enforcement's exhibits are cited as CX, while Respondent's exhibits are cited as RX.

II. Findings of Fact and Conclusions of Law

The burden of proof in a TCDO proceeding is the same as in a disciplinary proceeding.⁶ Accordingly, this Decision incorporates by reference the Findings of Fact and Conclusions of Law in the TCDO Decision of August 30, 2004. The Panel assumes familiarity with the TCDO Decision, which is attached as Exhibit A, and will primarily focus on evidence presented and issues raised during the disciplinary proceeding.

A. Sale of Unregistered Securities

The first cause of the Complaint charges that in connection with the 2003 private placement self-offering, LH Ross violated NASD Conduct Rule 2110 (by virtue of violating Section 5 of the Securities Act of 1933) by offering and selling securities through the mails and in interstate commerce without filing registration statements with the SEC. The Complaint further alleges that LH Ross failed to comply with registration exemptions upon which it purportedly relied.

In the 2003 private placement memorandum (2003 PPM), LH Ross claimed an exemption from registration based on Section 4(2) of the Securities Act for non-public offerings, and under Rule 506 of Regulation D promulgated thereunder for offerings that involve no more than 35 unaccredited investors.⁷ The record shows that LH Ross sold its preferred stock to at least 150 investors in 27 states, including approximately 54 unaccredited investors. (Tr. 1087-1088, 1093, 1097; CX –10, pp. 2, 10; CX-12; CX-208A; CX-208 – CX-261.)

⁶ See *Dep't of Enforcement v. Belden*, No. C05010012, 2002 NASD Discip. LEXIS 12, at *20 (NAC Aug. 13, 2002) (burden of proof in NASD disciplinary proceeding is preponderance of the evidence) (internal citations omitted); NASD Rule 9840(a).

⁷ Under Rule 501(a), an accredited investor includes the following: any bank, insurance company or employee benefit plan, any business development company, non-profit corporations, insiders, any person with a net worth of more than \$1 million, and any person with an annual income of more than \$200,000 (or combined total of \$300,000 for married couples).

The burden of proving that the offering did not need to be registered falls on the issuer.⁸ LH Ross acknowledged it could not meet this burden, and the record supports this concession. Accordingly, the Panel finds, and Respondent concedes, that LH Ross violated NASD Conduct Rule 2110 by virtue of violating Section 5 of the Securities Act of 1933, by participating in public offerings and sales of unregistered securities in connection with the 2003 private placement offering of LH Ross preferred stock, as charged in the first cause of the Complaint.

B. Fraud

The second cause of the Complaint charges that LH Ross, through its registered representatives, agents and employees, made material misrepresentations and/or omissions of material facts in connection with the offer and sale of securities issued by Respondent, and acted with scienter, in violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110.

Based on the evidence presented at the TCDO hearing, the Panel found by a preponderance of the evidence that LH Ross representatives made material misstatements and omissions of material facts, as well as unfounded price predictions, in soliciting customers to invest in the firm's preferred stock in the 2003 and 2004 private placement self-offerings. In addition, the Panel noted that the firm's representatives used high-pressure sales tactics. Brokers called some customers several times, and many brokers urged customers to act quickly before the "limited opportunity" expired. Some brokers offered free stock as an incentive, and one broker guaranteed he would pay dividends from his own pocket if necessary. Another broker

⁸ See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); see also *Kunz v. SEC*, 2003 U.S. App. LEXIS 6011, at **17, 19 (10th Cir. 2003) (internal citation omitted).

had the temerity to suggest that a customer invest another \$100,000 before the price doubled, without divulging that LH Ross had arbitrarily doubled the stock price in the 2004 offering.

Based on all the credible evidence, the Panel concluded that LH Ross representatives, who stood to benefit from their material misrepresentations and omissions and high-pressure sales tactics, intended to deceive, manipulate or defraud investors, and acted with scienter. Accordingly, the Panel found that LH Ross, which is liable for the misconduct of its registered representatives, violated the antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, as well as NASD Conduct Rules 2120 and 2110.⁹

The Panel further found the Respondent's transgressions included a pattern of: failing to send the private placement memorandum to customers or sending it well after the purchase; failing to reflect the acquisition of preferred stock on customers' monthly account statements; telling customers their investment had doubled without divulging that the firm had simply doubled the price of the preferred stock in the 2004 offering; making additional material misstatements to customers who posed questions about the offerings; completely ignoring many customer complaints about the offerings; and dissipating or misappropriating a significant portion of the millions of dollars raised in these self-offerings, which appear to be little more than a scheme to defraud investors.

At the disciplinary proceeding, Enforcement presented additional evidence related to the second cause of the Complaint, in the form of testimony from two customers and transcripts of on-the-record interviews with six customers. Enforcement introduced this evidence to counter

⁹ A violation of an SEC or NASD rule also constitutes a violation of Conduct Rule 2110's ethical obligation to observe high standards of commercial honor and just and equitable principles of trade. *See Steven J. Gluckman*, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395, at *22 (July 20, 1999) (citations omitted).

Respondent's argument that customers did not complain about the 2003 or 2004 private placement self-offerings until NASD contacted them during the investigation that gave rise to this proceeding. Enforcement also offered this evidence to demonstrate a pattern of misconduct by LH Ross representatives and to support its argument that expulsion is the appropriate sanction.

At the disciplinary hearing, Respondent presented additional evidence in its defense. Respondent introduced written agreements between the firm and eleven registered representatives to support its argument that brokers who engaged in wrongdoing were "independent contractors." According to Respondent, the brokers' misconduct is not legally attributable to LH Ross.

1. Additional testimony from customers

RO, a 65-year-old Pennsylvania resident, is semi-retired from the construction industry. He opened an account at LH Ross after receiving a call from Daniel or Fernando Fernandez.¹⁰ Fernandez called again in August 2003 to recommend that RO sell securities in his account in order to purchase LH Ross preferred stock. The broker asked RO to invest \$30,000 (for 21.43 units of stock at a cost of \$14 per share) and predicted the stock would soon sell for \$28 per share. Fernandez said that RO would "double his money" in two or three months and would also receive 6.5% interest on his investment in LH Ross. (Tr. 1264-1267; CX-383.)

Based on Fernandez's recommendation, RO liquidated his security positions worth \$16,000, and invested a total of \$30,000 in the 2003 private placement self-offering. When

¹⁰ RO's broker had "several names," and the Panel notes that on the purchaser questionnaire, RO listed his broker as Denis Fernandez. Throughout both hearings, there was confusion regarding Fernandez and whether he also used the name "Hernandez." According to Michelin, no broker named Hernandez worked at the firm, and he has not heard Fernandez refer to himself as Hernandez. (Tr. 1265, 1281-1284, 1544-1546; CX-384, p. 4.) Whether or not Fernandez used an alias is immaterial, as the Panel has fully credited the customers' testimony regarding the misstatements and omissions made by their LH Ross brokers.

soliciting RO to purchase LH Ross stock, Fernandez did not mention that the firm had not paid dividends since 2001, nor did he discuss the speculative nature of the investment. In fact, Fernandez did not mention any potential downside; rather, he told RO that he “couldn’t help but make money.” RO completed the purchaser questionnaire two days after he bought LH Ross preferred stock. He never received a copy of the 2003 PPM. (Tr. 1268, 1291-1292, 1297; CX-383 – CX-385; CX-387; CX-388.)

RO never received a stock certificate evidencing his purchase, nor was it reflected in his monthly account statements. He never received a dividend. RO testified that all he got was “run around.” He was told that Fernandez was on a leave of absence, and after several additional calls, he eventually spoke to the branch manager, Adam Forman. RO concluded that “something funny” was going on when Forman told him that LH Ross had terminated Fernandez. RO contacted a friend in the securities industry, who informed him that NASD was investigating LH Ross. RO then called LH Ross daily to request a refund of his investment. In response, Forman said he would send the stock certificate, assuring RO that “everything will be fine.” (Tr. 1267-1270, 1276, 1297-1298, 1300.)

When RO finally heard from Fernandez, he asked the broker to refund his money. Fernandez said he would discuss it with his boss, Frank Michelin, and later reported that Michelin said RO had signed a contract allowing LH Ross to hold his money as long as the firm desired.¹¹ Despite many calls to the firm, RO did not receive his stock certificate, nor the refund

¹¹ Michelin was apparently referring to the purchaser questionnaire, which asks if the prospective investor is aware that the offering requires the investment to be maintained for “an indefinite period.” When asked about the purchaser questionnaire and other forms bearing his name, RO did not recall checking some of the boxes, nor indicating that his net worth was \$400,000. He also noted that the handwriting on the subscription agreement was not his. (Tr. 1279-1281, 1290; CX-384; CX-385, p. 7.)

he requested. Instead, Fernandez told him that everything was fine, and that LH Ross should be able to go public in November 2004. (Tr. 1271-1272, 1274.)

NASD first contacted RO regarding LH Ross in June 2004, at least two months after he began complaining to the firm weekly.¹² RO has not had contact with LH Ross since late September or early October 2004 and is “aggravated about this situation.” He considers Fernandez “a liar and a thief” and intends to file a written complaint. (Tr. 1273, 1296.)

WT is an 84-year-old World War II veteran, who lives in Austin, Texas. He opened an account with LH Ross in May or June 2003, after receiving a cold call from Sean Ryan. After telling Ryan about problems he was having with brokers who “weren’t making [him] any money,” Ryan offered to “take care of that.” WT opened an account at LH Ross, and Ryan subsequently recommended that he invest in LH Ross’s private placement self-offering.¹³ WT also dealt with LH Ross brokers Dante Calicchio, Adam Forman and Dan Fernandez, and at some point, he authorized LH Ross to move his account from one branch office to another. He could not recall specifically what Ryan or Calicchio said when soliciting him to purchase the preferred stock, but remembered they told him that LH Ross was making money, hiring more brokers, and that an investment in the firm would be a “good thing.” WT also remembered

¹² Respondent argued at the TCDO hearing that customers did not complain about the 2003 private placement until NASD contacted them. The evidence presented at the TCDO hearing did not support this contention. At the disciplinary hearing, Enforcement presented additional evidence showing that several customers had registered complaints with the firm about the 2003 private placement prior to receiving NASD’s letter dated June 17, 2004. In these complaints, some customers protested unauthorized purchases of LH Ross preferred stock, some criticized tactics employed by LH Ross brokers, many were upset that their complaints had been ignored by their broker and/or Michelin, and most requested a refund of the investment and/or to close their LH Ross accounts. (Tr. 1117-1118, 1126-1128, 1130, 1141, 1143; CX-319; CX-333; CX-334; CX-342; CX-345 – CX-347; CX-350 – CX-354; CX-359; CX-414; CX-415.) Enforcement also introduced a complaint filed with the SEC on September 29, 2003 by customer RS and correspondence related to it. (CX-354 – CX-358.)

¹³ To open his LH Ross account, WT closed fourteen accounts at other brokerages, including an IRA account; he had opened each of these accounts after receiving a cold call from a broker soliciting his business. Closing the IRA account caused WT to incur considerable tax liabilities. (Tr. 1311, 1321, 1323, 1333.)

references to some successful IPOs and being told that LH Ross would go public by the end of 2003. As that time approached, however, LH Ross brokers told him there were problems with paperwork and “the usual delays,” but the IPO would take place during the spring of 2004. At some point, he spoke with Michelin, who “reinforced” what the brokers had told him. (Tr. 1309-1310, 1312-1314, 1317-1320, 1325, 1329.)

WT first purchased shares of LH Ross preferred stock in July 2003 and has invested a total of \$173,000 or \$174,000 in the 2003 and 2004 private placement self-offerings. He spoke with Calicchio at least once a week and repeatedly asked for documentation regarding his investment. In the spring of 2004, he received what he believes was a stock certificate, reflecting his ownership of 8,000 units of LH Ross. WT testified he would be “very pleased” if LH Ross “goes through the process that was explained [to him], and it gets to being negotiable stock” Otherwise, he will not be satisfied with his investment and noted “it’s not moving very quickly.” He did not complain about LH Ross but was contacted by authorities in Texas and by NASD and was “happy to hear that somebody was interested.” According to WT, he had “so many other things to worry about that [he] hoped somebody would worry about [his investment] if it needed to be worried about.” (Tr. 1314-1315, 1322, 1334-1341; CX-389 – CX-392.)

In addition to calling RO and WT, Enforcement introduced transcripts of on-the-record interviews with six customers who purchased LH Ross preferred stock in the 2003 private placement offering. Four of these customers (WS, TL, TLL, ND) never received the PPM, while one customer (JU) received the PPM after his initial purchase. Only one customer (FL) received the PPM prior to his purchase, though he did not completely understand the document.¹⁴ The

¹⁴ The Panel notes that some of these six customers dealt with LH Ross brokers who were not mentioned during the TCDO hearing – Steve Labadie, Neil Herzog, Mitchell Weisberg, Jordan Scales and Marc Valenzuela.

customers' recitations regarding the 2003 offering were essentially consistent with RO's testimony, as well as the evidence presented at the TCDO proceeding regarding material misstatements and omissions of material facts by Respondent's brokers in soliciting purchases of LH Ross preferred stock. (CX-262; CX-269; CX-280; CX-286; CX-297; CX-299; CX-311.)

According to one of the transcripts, TLL invested \$70,000 in October 2003 after speaking to Marc Kimmel, who identified himself as chief of investment banking for LH Ross. Kimmel stated that the firm had obtained all needed approval for an IPO, which should occur in the next three or four months. Kimmel said "that short of a nuclear war, there was nothing that could hold up the IPO." Kimmel also promised a 6% cumulative dividend, which was important to TLL, who needed to borrow a portion of the money he invested in LH Ross. (CX-286; CX-287; CX-289; CX-292.)

TLL wired funds to LH Ross before receiving the subscription package. He never received a copy of the 2003 PPM, nor any dividends. On April 28, 2004, he wrote to LH Ross to request a full refund. After receiving a letter from the firm stating the matter would be investigated within 30 to 45 days, TLL wrote another letter on July 1, 2004, and received a call from the compliance department.

On August 18, 2004, TLL again wrote to LH Ross, referred to NASD's request for a TCDO, and again requested a refund. He received a call from Michelin, who said the firm was going public and would be filing a registration statement in approximately three weeks. Michelin said that after the IPO, TLL would make "a lot of money . . . [and] ought to be thanking [LH Ross] and wondering if [he] can invest more." Michelin told TLL he could not refund his money. (CX-286; CX-288; CX-290, p. 24; CX-293; CX-295.)

Since at least 2002, LH Ross told customers that LH Ross stock purchased in the private placement self-offerings would be publicly traded. However, as of October 8, 2004, the firm had not filed a registration statement with the SEC to trade the stock publicly. (Tr. 1138-1140; CX-412; CX-413.)

2. LH Ross brokers

Respondent did not offer testimony from registered representatives who solicited customers to purchase LH Ross preferred stock in the 2003 or 2004 offerings. Rather, Respondent argued that it was not legally responsible for fraud committed by its registered representatives. To that end, Respondent introduced registered representative agreements with eleven brokers, which purportedly conferred “independent contractor” status on these individuals.¹⁵ According to Michelin, all registered representatives at LH Ross have a contractual relationship with the firm, as reflected in these agreements. (Tr. 1478-1479; RX-4 – RX-15.)

The relevant provision reads in pertinent part:

It is understood and agreed by the parties that the RR is an independent contractor and nothing contained herein shall be construed to create a relationship of employer/employee between the Company and the RR. . . . The RR is not under the direction or control of the Company but his methods and manner of solicitation must be in accordance with the Company’s Compliance Manual, a copy of which is attached hereto, and other policies, the applicable rules and regulations of the [SEC] . . . [and] NASD¹⁶

In the agreements, LH Ross and its registered representatives also acknowledge “the highly regulated nature of the securities industry and the importance of compliance with the rules

¹⁵ The eleven are: Lazar Kauderer, Adam Forman, Sean Ryan, Kristian Sierp, Mitchell Weisberg, Marcus Valenzuela, Jeffrey Esposito, Fernando Fernandez, David Licht, Mason Newman and Mark Perretta. (RX-4; RX-6 – RX-15.) Respondent also introduced a copy of a “branch licensee agreement” between LH Ross and Adam Forman. (RX-5.) Five of the agreements, which appeared to be identical, were not fully executed.

¹⁶ LH Ross did not offer in evidence a copy of its Compliance Manual or any excerpts therefrom.

and regulations imposed by [regulatory authorities],” among others. The agreement reinforces that the registered representative “shall at all times operate in accordance with all internal rules, regulations, policies, requests, directives, memoranda and the like of [LH Ross], as well as . . . rules [and] regulations [of] . . . the SEC [and] NASD Non-compliance may result in disciplinary action, up to and including . . . termination” (RX-4; RX-6 – RX-15.)

Moreover, Michelin testified that LH Ross retained a consulting company two or three years ago to audit the firm and provide procedures designed to help branch offices coordinate compliance with corporate headquarters. As a result of this audit, Michelin, who testified that he became chief compliance officer in 2003, holds compliance meetings with his employees. He also visits branch offices, reviews trades, monitors customer accounts, and is involved in hiring branch managers and some registered representatives. (Tr. 1494, 1525-1526, 1734, 1762-1765.)

Michelin testified that over the years, LH Ross has hired registered representatives from firms with regulatory problems, including two or three firms that were expelled from the industry for engaging in abusive sales practices. After hiring several registered representatives from one such firm, LH Ross recently terminated these brokers. If the firm had not done so, it would have been required to install a taping system to record conversations between LH Ross brokers and customers or prospective customers under NASD Rule 3010(b)(2).¹⁷ (Tr. 1738-1740, 1742-1746.)

¹⁷ Known as the “taping rule,” it requires a member to establish special supervisory procedures, including the tape recording of conversations, when it has hired more than a specified percentage of registered persons from certain disciplined firms. The rule is intended to ensure that a firm that hires a significant number of employees from previously disciplined firms properly supervises its sales force to prevent fraudulent and improper sales practices. *Dep’t of Enforcement v. Michelin*, No. C0700033, 2002 NASD Discip. LEXIS 1, at *2 (NAC Jan. 3, 2002).

3. Discussion

The Hearing Panel fully credits the testimony of RO and WT¹⁸ and notes that Respondent does not challenge their credibility, nor the Panel’s previous findings regarding fraudulent misrepresentations and omissions by LH Ross registered representatives. In fact, during closing argument, Respondent’s counsel stated that “LH Ross accepts that there were registered representatives who committed violations of the anti-fraud provisions of the federal securities laws and NASD Conduct Rules . . . [and] any argument to the contrary is legally inept, disconnected from reality, and would be embarrassingly divorced from the concept of candor.”¹⁹ Instead, Respondent relies on one simple argument: that it is not legally responsible for the conduct of its registered representatives, because they are “independent contractors.”

Respondeat superior is a common law theory of secondary liability, which holds an employer or other principal legally responsible for the conduct of an agent. Under this doctrine, an employer is liable for a tort committed by one of its employees acting within the scope of his employment, or for a misleading statement made by an employee or other agent who has actual or apparent authority. *See Restatement (Second) of Agency* §§ 219, 257, 261 (1958).

Respondeat superior has been applied in the broker-dealer context in many decisions, including

¹⁸ Though hearsay, the Hearing Officer admitted in evidence transcripts of six customer interviews, because they bore sufficient indicia of reliability – the witnesses were under oath, and the interviews were transcribed by a court reporter. Nevertheless, there was no opportunity for cross-examination of these witnesses, and the Panel found the interviews of FL and TL confusing. Accordingly, the Panel has considered the transcripts and given them some weight, but is basing its findings primarily on the testimony of nine customers who testified at the TCDO hearing and two customers who testified at the disciplinary hearing.

¹⁹ Tr. 1797.

Douglass and Co., Inc., Admin. Proc. No. 3-4981, 1977 SEC LEXIS 2778, at **31-32 (May 27, 1977) (internal citations omitted), which the Panel cited in the TCDO decision.²⁰

If a person is an “independent contractor,” however, *respondeat superior* does not apply, and the principal cannot be held liable for his or her misconduct. *See Restatement (Second) of Agency* § 220 (1958). Whether an individual is an agent or independent contractor turns on whether the principal has the right to control how the person’s work will be performed. *Id.*

The record does not support Respondent’s assertion that LH Ross brokers were “independent contractors.” As evidenced by the agreements themselves, the brokers were under the supervision of Michelin and LH Ross. Furthermore, they were registered representatives of LH Ross. They acted at the behest of, and on behalf of, LH Ross when soliciting the public to invest in LH Ross. Respondent is thus responsible for their misconduct.²¹

²⁰ While some have questioned whether *respondeat superior* liability still exists under Section 10(b) after the Supreme Court’s decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994) (aiding and abetting liability is not available in a private suit for damages under Section 10(b)), the Panel notes the NAC’s holding that *Central Bank* does not apply to NASD’s interpretation of NASD Rules. *Dep’t of Enforcement v. Perles*, No. CAF980005, 2000 NASD Discip. LEXIS 9, at *20 (NAC Aug. 16, 2000), *aff’d in part*, Exchange Act Rel. No. 45691, 2002 SEC LEXIS 847 (Apr. 4, 2002). Thus, even if *Central Bank* precludes *respondeat superior* liability for Section 10(b) violations, Respondent is properly held liable in this proceeding under *respondeat superior* for violating NASD Conduct Rule 2120, which should be “interpreted flexibly, with a view toward eliminating fraud[.]” *Perles*, at *23.

The Panel believes that imposition of *respondeat superior* liability for Respondent’s violation of Section 10(b) is consistent with the plain language of the statute, defining “person” to include a company, which is liable under agency principles. In our view, the decision in *Central Bank* does not warrant a different conclusion. *See, e.g., Vento & Co. v. Metromedia Fiber Network, Inc.*, 1999 U.S. Dist. LEXIS 3020, at *37 (S.D.N.Y. 1999) (no indication that Supreme Court intended to preclude liability of a principal for the misconduct of its agent in *Central Bank*).

²¹ Even if the brokers were not registered, LH Ross was responsible for their conduct in soliciting customers to purchase stock. *Cf. Dist. Bus. Conduct Comm. v. Deltavest Financial, Inc.*, No. C02930042, 1994 NASD Discip. LEXIS 221, at *24 (NBCC June 27, 1994), citing *Van Alstyne, Noel & Co.*, Exchange Act Rel. No. 8511, 1969 SEC LEXIS 299, at *16 (Jan. 31, 1969) (independent contractor who performed usual and customary functions of an investment banker was a “controlled” person and considered an employee of the broker-dealer).

The Panel does not believe that the legal concept of an “independent contractor,” which relates to civil liability, has any application in the context of an NASD enforcement action. Under NASD Rules, firms are obligated to supervise the activities of their registered representatives and other associated persons. To hold that registered persons are “independent contractors,” thereby absolving the firm from responsibility for their misconduct, would be antithetical to the rules requiring firms to exercise care in hiring and supervising their employees and agents.

Moreover, Michelin testified that LH Ross hired several brokers from firms with regulatory problems, including abusive sales practices. LH Ross also hired one person, as vice president for investment banking, who was awaiting sentencing for his felony conviction for conspiracy to commit mail and wire fraud.²² These individuals should have been subjected to heightened supervision. Respondent’s argument that it is not responsible for fraud committed by its registered representatives – particularly under these circumstances – is utterly specious.

Furthermore, several customers testified that when they complained to Michelin about the private placements, he again touted the investment without disclosing all of the risks, and misrepresented the status of the IPO. Even if he did not make such statements, he nevertheless knew from these complaints that his salesmen were making false claims and did nothing to curtail their fraudulent activity. That the firm’s CEO, CFO, COO, President and Chief Compliance Officer was aware of this misconduct and took no corrective action, further supports

²² Lazar Kauderer joined LH Ross in October 2003, ten months after pleading guilty in federal court to conspiracy to commit mail and wire fraud. He was sentenced to two years’ imprisonment in March 2004. (CX-204; CX-205; CX-424.)

a finding that LH Ross is liable for antifraud violations committed by its registered representatives.²³

Based on the totality of the evidence, including the fact that Michelin stood to make millions from these offerings and was paying brokers exceedingly high commissions for selling LH Ross preferred stock, the Panel does not credit Michelin's testimony that he was unaware of the fraudulent and abusive sales tactics used by LH Ross brokers in soliciting customers to purchase in the private placement self-offerings. In fact, it is reasonable to infer that he expected, even directed, the firm's brokers to do so. Even if he did not, however, LH Ross is responsible for the sales practices of its brokers, for the reasons stated above.

The Panel thus confirms its previous conclusion that LH Ross, through its registered representatives, made material misrepresentations and omissions of fact in connection with the offer, sale or purchase of securities issued by Respondent in its 2003 and 2004 private placement self-offerings and thereby violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, as charged in the second cause of the Complaint.

C. Unauthorized Transactions

The third cause of the Complaint charges that Respondent violated NASD Conduct Rule 2110 by placing unauthorized transactions in customer accounts involving purchases of

²³ As previously noted in the Panel's order of September 17, 2004, denying Respondent's motion to vacate the TCDO, LH Ross is also liable for the conduct of its registered representatives under Section 20(a) of the Exchange Act. This section provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of [the Exchange Act] or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person . . . unless the controlling person acted in good faith . . ." As a matter of law, a broker-dealer is a control person under Section 20(a) with respect to its registered representatives and is liable for their violations of Section 10(b) of the Exchange Act, even if they are "independent contractors." See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1572-78 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991). The record does not support a finding that LH Ross acted in "good faith."

securities issued by LH Ross in the 2003 and 2004 private placements. Based on the evidence presented at the TCDO hearing, the Panel found that LH Ross, through one or more of its representatives or employees, executed unauthorized transactions in customer KC's account and falsified two documents in furtherance of this misconduct. In so doing, the firm violated NASD Conduct Rule 2110. The Panel also noted GooD y's testimony that several other customers had complained about unauthorized transactions.

Neither party introduced additional, credible evidence regarding this cause of the Complaint.²⁴ Thus, the Panel confirms its previous conclusion that Respondent violated NASD Conduct Rule 2110 by placing unauthorized transactions in at least one customer account involving purchases of securities issued by LH Ross in the 2003 and 2004 private placements.

D. NASD's Requests for Information and Documents

The fourth cause of the Complaint charges that Respondent failed to respond to NASD's requests for documents and information regarding LH Ross private placement offerings, in violation of NASD Procedural Rule 8210 and Conduct Rule 2110. There is no dispute that the requests were properly issued under Rule 8210, nor any dispute that Respondent received them. The sole issue is whether Respondent's failure to provide information and documents in response to the staff's letters dated June 17, July 8 and July 16, 2004, constituted a violation of NASD's rules. We conclude that it does.

1. NASD requests

NASD initiated the investigation that gave rise to this disciplinary proceeding in April 2004. The staff conducted on-site inspections of LH Ross offices and sent a letter to the firm

²⁴ Enforcement introduced transcripts of interviews with TL, FL and ND, who seem to accuse LH Ross of executing unauthorized transactions in their accounts, but the interviews were confusing, and the testimony was equivocal. Accordingly, the Panel finds that Enforcement did not prove by a preponderance of the evidence that Respondent violated NASD Conduct Rule 2110 with respect to the accounts of TL, FL and ND. (CX-280; CX-297; CX-311.)

requesting documents and information.²⁵ The staff also discussed the private placement self-offerings with Michelin, and asked him to stop the offerings voluntarily. (Tr. 1231, 1489; CX-190.)

NASD again requested information and documents related to the private placement offerings by letter dated June 17, 2004. GooD y sent the request letter to Barry Wattenberg of LH Ross via facsimile and first class mail. The staff made the request pursuant to NASD Procedural Rule 8210 and warned that failure to comply with the request could lead to disciplinary action. The staff asked the firm to respond by July 1, 2004, and to submit a written explanation for any item that could not be produced. (CX-191.)

In response, Wattenberg phoned GooD y and told her he had forwarded the request to Michelin and Adam Simon.²⁶ On July 1, 2004, an attorney for LH Ross told Enforcement that the firm was unable to meet the deadline. By letter dated July 1, 2004, Enforcement refused to extend the deadline and warned that if LH Ross did not supply requested information and documents by electronic mail or facsimile that day, “the staff will consider the firm to be in violation of Procedural Rule 8210, and [the staff] will proceed as we deem appropriate.” (Tr. 1215; CX-193.)

On July 8, 2004, GooD y sent a letter to Michelin via facsimile, first class and certified mail, renewing the June 17th request for information and documents regarding the private

²⁵ NASD requested information related to the 2002, 2003 and 2004 private placement offerings by letter dated May 25, 2004. In response, Barry Wattenberg of LH Ross asked GooD y to obtain copies of the requested information from the Florida Office of Financial Regulation. After reviewing information provided by the Florida authorities, the staff issued the request letter dated June 17, 2004, which forms the basis for the charges contained in the fourth cause of the Complaint. (Tr. 1258-1261; CX-189; CX-191.)

²⁶ In a letter addressed to GooD y dated June 18, 2004, Wattenberg explained that he was an associate in the compliance department at LH Ross, who “should not be the addressee or the responsible responder under [R]ule 8210.” Wattenberg wrote that “communications of this nature” should be addressed to Michelin as chief compliance officer for LH Ross. According to Wattenberg, copies of NASD’s request letter had been forwarded to Michelin and Simon. (Tr. 42; CX-192.)

placement offerings. The renewed request was made pursuant to Rule 8210, and GooD y set July 14, 2004 as the deadline for compliance. She attached a copy of the June 17th letter.

(CX-194.)

On July 14, 2004, the staff received an undated letter on LH Ross letterhead via facsimile. The letter had Michelin’s name in the signature block and was marked: “stamped w[ith] instruction from Frank Michelin.” Though Michelin’s letter primarily focuses on Enforcement’s request that Michelin appear for investigative testimony, he states that “they (sic) are several 8210 requests with respect to the private offerings for which I have not had the time to prepare the information requested.” As for his investigative testimony, Michelin states that from “this point forward, I need to zone in and focus completely on [an NASD disciplinary proceeding] scheduled for the first week of August” He offered to meet with the staff two days after the conclusion of the hearing. (CX-196, p. 15.)

By letter dated July 16, 2004, Enforcement again asked for information and documents related to the private placement offerings and advised Michelin that the firm had failed to comply with NASD’s June 17, 2004 request, which was reiterated in the staff’s July 8, 2004 letter. Enforcement warned that failure to comply with this third and final request could be the basis for the initiation of a disciplinary proceeding against LH Ross. Enforcement’s request was again made pursuant to Rule 8210, and a deadline of July 20, 2004 was imposed. All previous correspondence was attached to this letter. (CX-196.)

By letter dated July 20, 2004, A.F., counsel for LH Ross, told Enforcement that Michelin “is in a period of seclusion preparing for [an NASD disciplinary proceeding,] which is scheduled to commence on August 2, 2004. . . . [He] is the only one who has sole access to all of the information requested.” Nevertheless, A.F. intended to coordinate with LH Ross staff to gather

“as much of the information which has been requested by the NASD over the next few weeks.” A.F. cautioned that Michelin, who needed to review and supplement the information, would not have an opportunity to do so until at least two weeks after the conclusion of the NASD disciplinary proceeding, which he believed would last three weeks. Finally, A.F. wrote that LH Ross had previously provided originals of all subscription documents and a schedule of investors in the 2003 private placement offering and “will do the same” with respect to the other offerings. (CX-197.)

On July 23, 2004, NASD filed the Complaint in this matter, as well as the Notice initiating the TCDO proceeding. As of October 18, 2004, Respondent had failed to provide any of the information or documents requested by the staff in its June 17, 2004 letter. (Tr. 1208-1213, 1224-1226, 1229, 1242-1246.)

2. Information supplied by LH Ross

According to Michelin, his first reaction to the June 17th letter was that NASD “[has] all of this [information] already.” Michelin testified that LH Ross had provided much of the requested information in on-site inspections NASD conducted before June 17, 2004. He did concede, however, that the firm had provided some of the information to the State of Florida, rather than to NASD. He also admitted that the firm had not provided to NASD some of the requested information, including information or documents related to LH Ross becoming a publicly traded company and information about a broker at the firm. (Tr. 1554, 1560-1563, 1565-1567, 1570, 1574-1575, 1579.)

Michelin further testified that the firm made a “good faith effort” to respond to NASD requests made between May 4 and June 17, 2004, but he was unable to respond to the June 17th request due to his cousin’s death in late June and the need to prepare for another NASD disciplinary proceeding scheduled to begin on August 2. He also claimed that the firm has spent

an “exorbitant amount” in staff time and copy expenses in responding to 8210 requests and declared that NASD has “almost everything” in the firm’s files. (Tr. 1487, 1555, 1572-1574.)

On October 5, 2004, LH Ross sent to Enforcement a two-page letter with a 91-page attachment that outlines the firm’s use of proceeds raised in the private placement offerings from January 2003 through June 2004. It is a summary document that Michelin created in response to an 8210 request dated October 1, 2004; it may also be considered responsive to the staff’s June 17th request for an accounting of the use of proceeds. Michelin testified that it took him a “long time” to prepare this document. It does not, however, provide all of the information Enforcement requested regarding the use of proceeds obtained in the 2002, 2003 and 2004 offerings. (Tr. 1145-1147, 1155, 1555-1556; CX-417.)

Specifically, Respondent failed to provide: the name of the escrow and/or bank account(s) in which the proceeds were deposited; the financial institution at which the account(s) is held; the account number(s); the person(s) with authority to withdraw funds from the account(s); the date and amount of withdrawals from the account; and to whom the withdrawals were payable.²⁷ (Tr. 1205, 1208, 1558; CX-191; CX-417.)

3. Discussion

Procedural Rule 8210 provides that NASD “staff shall have the right to require a member . . . to provide information . . . with respect to any matter involved in [an] investigation” Rule 8210 further states that “no . . . person shall fail to provide information . . . pursuant to this Rule.”

²⁷ Michelin testified that in preparing this document, he took information from the firm’s books and records, but the Panel notes that the document often lacked detail. For example, it reflects transfers from LH Ross to a branch office on 49 separate occasions “for offering costs and commissions.” Each transfer is reported as a lump sum, in amounts ranging from \$400 to \$290,000. Other than the date, no additional information, such as the name of the individual to whom the commission was paid or the location of the branch office receiving the funds, is provided. (CX-417.)

In the absence of subpoena power, NASD must rely on Rule 8210 to obtain information from members in the course of its investigations. *Dep't of Enforcement v. Quattrone*, No. CAF030008, 2004 NASD Discip. LEXIS 17, at *46 (NAC Nov. 22, 2004). For this reason, the SEC has “repeatedly stressed the importance of cooperation in NASD investigations[,] . . . [and] emphasized that the failure to provide information undermines the NASD’s ability to carry out its self-regulatory functions.” *Joseph P. Hannan*, Exchange Act Rel. No. 40438, 1998 SEC LEXIS 1955, at *9 (Sept. 14, 1998) (internal citations omitted).

Accordingly, members and associated persons have a duty to cooperate fully and promptly with NASD requests for information. *Brian L. Gibbons*, Exchange Act Rel. No. 37170, 1996 SEC LEXIS 1291, at *7 (May 8, 1996), *aff'd*, 112 F.3d 516 (9th Cir. 1997). Failure to comply is a serious violation because it subverts NASD’s ability to carry out its regulatory responsibilities. *Hannan*, 1998 SEC LEXIS 1955, at *9 (citation omitted).

Firms may not impose conditions on their responses or determine the appropriate time for responding to 8210 requests. *Charles R. Stedman*, File No. 3-8298, 1994 SEC LEXIS 4235, at **8-9 (Aug. 10, 1994). Nor should NASD have to bring a disciplinary proceeding in order to obtain compliance with its rules relating to investigations. *John A. Malach*, Exchange Act Rel. No. 32743, 1993 SEC LEXIS 2026, at *7 (Aug. 12, 1993).

The Panel credits GoodDey’s testimony that Respondent failed to provide information and documents the staff requested on June 17, July 8 and July 16, 2004, and finds Respondent’s arguments to the contrary unpersuasive and legally flawed. Essentially, the firm’s response was to refer the requests to outside counsel, which is not an adequate response. *Hannan*, 1998 SEC LEXIS 1955, at *9.

Though Michelin may have believed that NASD obtained some of the requested documents from on-site inspections of several LH Ross offices or from the State of Florida, his firm cannot ignore 8210 requests on that basis. Furthermore, the Panel notes that he offered this explanation at the hearing but failed to include it in any correspondence with NASD regarding the staff's 8210 requests, as he was obligated to do. *Id.*

Moreover, a firm may not offer to comply with an 8210 request when it is most convenient, as LH Ross did here. More than one month after the staff's initial request, Respondent's counsel wrote that they "*intend to coordinate* with LH Ross staff members to gather as much of the information which has been requested by the NASD *over the next few weeks.*" (Emphasis added.) Counsel went on to state that Michelin, who had been "involved for the past couple of weeks on various matters involving the NASD . . . would not have an opportunity to complete his review [of the requested information] until at least two weeks after the conclusion of [another NASD] proceeding."

In other words, as of July 20, 2004, LH Ross had not yet begun to compile documents or made any attempt to comply with the staff's June 17, 2004 request for information about the private placement offerings. Nor did the firm intend to provide the information for at least another month. Given the circumstances of this case – that NASD had conducted on-site inspections of several LH Ross offices and had asked Michelin to cease the private placement offerings voluntarily – the Panel believes that Respondent's lack of cooperation was an attempt to obstruct NASD's investigation of this ongoing fraud.

Finally, Respondent's submission of October 5, 2004 may have been tendered in part as a response to the staff's June 17th request. Based on the letter accompanying the submission, however, the Panel believes Michelin prepared the document in response to specific findings in

the TCDO Decision regarding the apparent misappropriation of funds raised in the private placement offerings, and the staff's 8210 request dated October 1, 2004. In any event, it was sent well after the Complaint was filed, and is not responsive to the staff's June 17th request for specific information regarding the use of proceeds from the 2002, 2003 and 2004 self-offerings.

The Panel thus finds that LH Ross did not fulfill its obligation to cooperate "fully and promptly" with the staff's 8210 request of June 17, 2004, nor with the subsequent requests. Accordingly, the Panel concludes that LH Ross violated NASD Procedural Rule 8210 and NASD Conduct Rule 2110 by failing to respond to NASD staff's requests for documents and information, as charged in the fourth cause of the Complaint.

III. Sanctions

In determining appropriate sanctions, the Panel considered NASD's Sanction Guidelines for each violation, as well as the Guideline's General Principles and Principal Considerations.²⁸ We also noted the firm's extensive disciplinary history, which is attached to this Decision as Exhibit B, as additional evidence of Respondent's disregard for regulatory requirements, investor protection and commercial integrity.

A. Private Placement Offerings

Respondent engaged in an ongoing course of conduct, selling unregistered securities using fraudulent and illegal sales practices.²⁹ Respondent's sale of unregistered securities in the form of convertible preferred stock in LH Ross in the 2003 private placement was inextricably intertwined with the fraud. The Panel aggregates the misconduct, because it stemmed from the

²⁸ Guidelines at 4-9.

²⁹ For selling unregistered securities, NASD Sanction Guidelines (2004 ed.) recommend a fine of \$2,500 to \$50,000, plus the amount of respondent's financial gain. A suspension up to two years or a bar may be imposed in egregious cases. *See* Guidelines at 28. For egregious cases involving misrepresentations or material omissions of fact, the Guidelines recommend expelling a firm. Guidelines at 94.

same course of action. *Cf. Dep't of Enforcement v. J. Alexander Securities, Inc.*, No. CAF010021, 2004 NASD Discip. LEXIS 16, at *69 (NAC Aug. 16, 2004).

The Panel finds that Respondent's misconduct was egregious and agrees with Enforcement that expulsion is warranted. LH Ross's activity involved intentional acts and a pattern of misconduct, covering two private placement offerings over a period of almost two years.

In essence, LH Ross operated a boiler room. The firm engaged in a concerted, high-pressure telephone campaign to sell unregistered securities in the form of units of convertible preferred LH Ross stock, showing little concern for the customers' investment needs or objectives. The firm employed false and deceptive means to solicit customers, who had no independent way to verify representations made by the brokers about the firm. Moreover, LH Ross frequently failed to send to customers the private placement memoranda until after their purchase, if at all. That Michelin never attempted to employ corrective measures or to remedy the misconduct after customers complained, further supports the Panel's conclusion that these offerings were simply a scheme to defraud investors, as does Respondent's attempt to obstruct NASD's investigation by failing to provide documents and information about the offerings.

The Panel is compelled to mention Respondent's blatant refusal to accept any responsibility for its misdeeds. Indeed, LH Ross and Michelin accused virtually everyone else of misconduct, including NASD and the Hearing Panel. They also faulted the firm's registered representatives, consultants, accountants, and most notably, its counsel. Though Respondent did not assert advice of counsel as a defense, it did attack the private placement memoranda drafted by A.F. and asked the Panel to consider his "incompetence" and "carelessness" as mitigation.³⁰

³⁰ Tr. 1089.

The Panel finds no mitigating factors, notwithstanding Respondent's spurious attempt to shift blame.³¹

In addition to expulsion, Enforcement asked the Panel to fine Respondent \$150,000 for these violations,³² and to order restitution of \$11,011,008, the total amount raised in the 2003 and 2004 private placement offerings, plus pre-judgment interest of at least \$450,113,87.³³ Because Respondent did not supply Enforcement with information about each purchase, the staff used Respondent's monthly FOCUS reports to calculate the amount invested in the offerings each month, and based its interest calculation on the monthly figure, and the amount due as of October 18, 2004, the date the disciplinary hearing commenced. Respondent agreed to this methodology, and in asking the Panel to stay this Decision for 90 days to allow the firm time to "marshal assets" and sell the firm in order to "make every effort . . . to return as much money as [it] can to investors," Respondent implicitly agreed that restitution is appropriate. The Panel concurs. (Tr. 1162-1168, 1367-1368, 1800; CX-422.)

Respondent nevertheless attempted to persuade the Panel that it is unable to pay monetary sanctions. We find, however, that LH Ross failed to provide any credible evidence of

³¹ The Panel notes that little, if any, of the misconduct here relates to preparation of the private placement memoranda or stock certificates, which were some of the purported problems with A.F.'s representation. We reject Respondent's deliberate attempt to cloud the issue and observe that Respondent called A.F., who has been counsel to LH Ross for ten years, as a witness at the TCDO hearing. Furthermore, A.F. made no representation regarding the veracity of the PPM, which was based in large part on information obtained from Michelin. According to the 2003 PPM, "[t]here can be no assurance that such information is complete or accurate." (CX-10, p. 29.)

³² Enforcement requested the imposition of a \$50,000 fine for selling unregistered securities, and a \$100,000 fine for material misrepresentations and omissions. The staff also requested a fine of \$75,000 for unauthorized trading.

³³ Prejudgment interest is calculated at the rate established for the underpayment of federal income tax in Section 6621 of the Internal Revenue Code, 26 U.S.C. 6621(a)(2) and generally runs from the date of the violative conduct. Guidelines at 12.

its alleged inability to pay, and note that the firm has yet to explain or document satisfactorily how the offering proceeds were disbursed.

As sole owner of Holdings, which owns LH Ross, Michelin alone determined the use of proceeds from these offerings and controlled the flow of funds between the two entities. He gave conflicting testimony throughout both proceedings, particularly when questioned by the Panel regarding the firm's and Holdings' finances. He was simply unwilling or unable to offer a direct answer to a direct question. Most, if not all, of his testimony cannot be believed, and the document he submitted regarding the use of proceeds is an amateurish summary that bears no indicia of reliability. In the absence of complete and reliable documentation, we reject Michelin's hearing testimony that all of the money was spent on business-related expenses, as well as Respondent's assertion that it is financially unable to pay restitution or a fine.

This case involves widespread, significant and identifiable customer harm, and the Panel believes that LH Ross and Michelin have retained substantial ill-gotten gains. For these reasons, the Panel imposes a fine of \$500,000 and orders Respondent to pay total restitution of \$11,011,008, plus pre-judgment interest. Respondent must make complete restitution to each customer who purchased LH Ross convertible preferred stock in the firm's 2003 and 2004 private placement offerings, plus pre-judgment interest from the date of purchase, calculated pursuant to Section 6621 of the Internal Revenue Code, 26 U.S.C. 6621(a)(2).

Finally, the Panel notes that once this Decision is issued, the TCDO is no longer in effect.³⁴ Any future attempt by LH Ross to solicit customers to invest in unregistered securities

³⁴ See Rule 9840(c). Respondent's application for review of the TCDO, which is currently pending with the SEC, may now be moot.

issued by the firm poses an extreme threat to the investing public. Accordingly, the Panel hereby imposes a permanent cease and desist order with all of the provisions included in the TCDO.³⁵

B. Failure to Respond

In egregious cases, a firm should be expelled for failing to respond truthfully, completely or timely to requests made pursuant to Procedural Rule 8210.³⁶ If mitigation exists, a suspension of up to two years is appropriate.³⁷

Without subpoena power, NASD must rely on the full and prompt cooperation of its members when conducting its investigations. To date, LH Ross has not complied with the staff's initial request, dated June 17, 2004, and has offered no reasonable explanation for its complete failure to respond. Instead, the firm has offered excuses. The Panel concludes that Respondent has refused to provide the requested information because it does not exist or contains information that is detrimental to the firm. In any event, the Hearing Panel finds this is an egregious case with no mitigating factors that would justify a sanction less than expulsion. In light of the expulsion and the sanctions imposed herein, the Panel will not impose a fine for this violation.

C. Unauthorized Trading

The Guidelines for unauthorized transactions recommend a fine of \$5,000 to \$75,000, plus the amount of financial gain; in addition, they recommend a suspension of 10 business days

³⁵ On October 13, 2004, Enforcement initiated a proceeding to cancel the membership of LH Ross for violating the provision of the TCDO requiring the firm to place \$2 million in escrow pending the completion of this disciplinary proceeding. In accordance with Rules 9556 and 9559, this Panel held a hearing regarding the alleged violation of the escrow provision on November 3, 2004 and prepared a written Decision, which was called for review by the National Adjudicatory Council Review Subcommittee on November 19, 2004. Though Respondent's defense was an alleged inability to comply with the escrow provision, the NAC Subcommittee asked the parties to address the Panel's authority to impose the escrow provision as part of the TCDO. However, the TCDO, which constitutes final disciplinary action by NASD, may only be reviewed by the SEC. *See* Rule 9870 and NTM 03-35.

³⁶ Guidelines at 37.

³⁷ *Id.*

to one year. In egregious cases, a longer suspension or a bar is recommended for an individual respondent. A suspension of up to two years should be considered for a member firm.³⁸

In view of the expulsions, no additional sanctions need be imposed for Respondent's violation of NASD Conduct Rule 2110 by placing unauthorized transactions in at least one customer account. *See Dep't of Enforcement v. Hodde*, No. C10010005, 2002 NASD Discip. LEXIS 4, at *17 (NAC Mar. 27, 2002).

IV. Conclusion

Respondent L.H. Ross & Company, Inc. violated: NASD Conduct Rule 2110 and Section 5 of the Securities Act of 1933, by participating in public offerings and sales of unregistered securities issued by Respondent through a private placement offering in 2003; and Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, through its registered representatives, who made material misrepresentations and omissions of material facts in connection with the offer, sale or purchase of securities issued by Respondent through private placement offerings in 2003 and 2004.

For these violations, LH Ross is fined \$500,000 and expelled from NASD membership. In addition, LH Ross is ordered to pay a total of \$11,011,008 in restitution to customers who purchased securities issued by the firm in its 2003 and 2004 private placement offerings, plus prejudgment interest calculated pursuant to Section 6621 of the Internal Revenue Code, 26 U.S.C. 6621(a)(2). A permanent cease and desist order is also imposed.

Respondent is also expelled for violating NASD Procedural Rule 8210 and NASD Conduct Rule 2110, by failing to respond to requests for documents and information. No further

³⁸ Guidelines at 100.

sanctions are imposed for violating NASD Conduct Rule 2110, by placing unauthorized transactions involving securities issued by Respondent through a private placement offering in 2003 in at least one customer account. Finally, Respondent is ordered to pay hearing costs of \$18,253.74, which includes an administrative fee of \$750 and hearing transcript costs of \$17,503.74.

These sanctions shall become effective on a date set by NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of NASD. Pursuant to Rules 9311(b) and 9312(b), any appeal of this Decision will not operate as a stay of the permanent cease and desist order, which is effective upon service.³⁹

V. Permanent Cease and Desist Order

Pursuant to Rule 8310, it is hereby **ORDERED** that Respondent L.H. Ross & Company, Inc.:

1. **CEASE AND DESIST** from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110. Specifically, Respondent is ordered to:

- a. cease and desist offering or selling securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;
- b. cease and desist offering or selling securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004; and
- c. cease and desist offering or selling any securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.

³⁹ The Hearing Panel has considered all of the arguments of the parties. They are sustained or rejected to the extent they are in accord or inconsistent with the views expressed herein.

2. **CEASE AND DESIST** from violating NASD Conduct Rule 2110. Specifically, Respondent is ordered to:

- a. cease and desist placing unauthorized transactions in customer accounts of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;
- b. cease and desist placing unauthorized transactions in customer accounts of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004; and
- c. cease and desist placing unauthorized transactions in customer accounts of securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.

3. **CEASE AND DESIST** from dissipating or converting customers' assets or causing other harm to investors. Specifically, Respondent is ordered to:

- a. cease and desist paying commissions or any other form of compensation to registered representatives in connection with sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;
- b. cease and desist paying commissions or any other form of compensation to registered representatives in connection with sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004;
- c. cease and desist paying commissions or any other form of compensation to registered representatives in connection with sales of securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.
- d. cease and desist making loans, paying bonuses, or giving any other form of compensation to registered representatives as inducement to join, or as reward for having joined, L.H. Ross & Company, Inc.;
- e. cease and desist making loans, paying bonuses, or giving any other form of compensation to branch managers or owners to be used to induce registered representatives to join, or as a reward for having joined, L.H. Ross & Company, Inc.;
- f. cease and desist opening new branch offices;

- g. cease and desist commingling funds between L.H. Ross & Company, Inc. and L.H. Ross Holding Corp.;
- h. cease and desist transferring, lending or otherwise distributing funds to L.H. Ross Holding Corp. from L.H. Ross & Company, Inc.;
- i. cease and desist forgiving, eliminating or writing off loans due from L.H. Ross Holding Corp. to L.H. Ross & Company, Inc.;
- j. cease and desist converting for personal use or misappropriating funds derived from sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;
- k. cease and desist converting for personal use or misappropriating funds derived from sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004;
- l. cease and desist converting for personal use or misappropriating funds derived from sales of securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.; and
- m. collect \$2 million due from L.H. Ross Holding Corp. to L.H. Ross & Company, Inc. and deposit \$2 million in an escrow account within 10 days of this Decision.⁴⁰

SO ORDERED.

Dana R. Pisanelli
Hearing Officer
For the Hearing Panel

Dated: January 14, 2005
Washington, DC

⁴⁰ The Hearing Panel reaffirms its conclusion that at least \$2 million raised in these fraudulent offerings, which Michelin transferred to Holdings, is due LH Ross. The Panel believes Michelin inappropriately consolidated the financials of the two entities in order to write off or excuse that debt as an uncollected receivable or allowance for doubtful account. (CX-417, pp. 1-2.) The Panel imposed the escrow provision to help ensure that if restitution were ordered after the full disciplinary hearing, LH Ross would be able to comply. LH Ross has failed to deposit any funds in escrow. The Panel thus orders Respondent to deposit \$2 million in an escrow account within 10 days of this Decision to ensure that the firm will be able to pay at least some portion of the restitution ordered in this proceeding.

Copies to: Gary Langan Goodenow, Esq. (*via facsimile and overnight mail*)
William Nortman, Esq. (*via facsimile and overnight mail*)
Franklyn R. Michelin (*via facsimile and overnight mail*)
Gary M. Lisker, Esq. (*via electronic and first class mail*)
Roger D. Hogoboom, Esq. (*via electronic and first class mail*)
Brian D. Craig, Esq. (*via electronic and first class mail*)
Rory C. Flynn, Esq. (*via electronic and first class mail*)⁴¹

⁴¹ The staff is reminded that it is the Office of Hearing Officers, and not Enforcement, that shall promptly serve this Decision on the parties. *See* Rule 9268.