NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RONALD PELLEGRINO (CRD No. 832857), Respondent.	Disciplinary Proceeding No. C3B050012 **HEARING PANEL DECISION** Hearing Officer – SW Dated: July 28, 2006

Respondent inadequately supervised registered representatives from July 2001 to March 2003, when he (i) failed to respond sufficiently to a red flag indicating possible misconduct by the representatives in the sale of unsuitable proprietary investment products, and (ii) unreasonably delegated responsibility for both compliance and supervision of more than 100 representatives to a single inexperienced individual, in violation of NASD Conduct Rules 3010(a) and 2110. For the violations, Respondent is suspended for six months in all capacities.

Appearances

Sylvia M. Scott, Esq., former Senior Counsel, Los Angeles, CA, and David C. Utevsky, Esq., Regional Counsel, Seattle, WA, for the Department of Enforcement.

Ronald Pellegrino, pro se.

DECISION

I. PROCEDURAL BACKGROUND

On October 16, 2003, Metropolitan Investment Securities, Inc. ("MIS" or the "Firm") executed an AWC consenting to findings that, from January 2001 to March 2003, MIS: (i) had inadequate supervisory systems and procedures in place; (ii) made unsuitable recommendations for the purchase of securities of affiliated entities, through its registered representatives, to numerous public customers; and (iii) disseminated,

through its registered representatives, misleading advertising sales literature to sell proprietary products. (CX-12d).

Subsequently, on May 12, 2005, the Department of Enforcement ("Enforcement") filed a one-count Complaint against Respondent alleging that Respondent, while employed as general manager of MIS, failed to provide adequate supervision from July 2001 to March 2003, in violation of NASD Conduct Rules 3010(a), 3010(b), and 2110.

Specifically, the Complaint alleges that Respondent violated NASD Conduct Rule 3010(a) by unreasonably delegating to a single inexperienced individual the sole responsibility for supervising more than 100 representatives, and by failing to implement adequate supervisory procedures. The Complaint alleges that the MIS representatives (i) made fraudulent sales presentations, including 57 unsuitable recommendations that amounted to fraud, to the customers set forth on Schedule A of the Complaint; (ii) made 108 unsuitable recommendations to the customers set forth on Schedule B of the Complaint; and (iii) disseminated misleading advertisements, which actions were the result of Respondent's lack of supervision.

In addition, the Complaint alleges that Respondent violated NASD Conduct Rule 3010(b) by failing to establish adequate written supervisory procedures because the written supervisory procedures in place at the time failed to address sales presentations for, and provide guidance on, the risk level of proprietary products, specifically, debentures, preferred stock, and investment certificates issued by two MIS-affiliated companies.

Respondent's Answer denies that his supervision was inadequate. Respondent argues that he neither knew nor had reason to know that the supervision was deficient

because there were no red flags, and that he appropriately delegated supervision of the MIS representatives to others.

The Hearing Panel, consisting of (i) a former member of the Board of Governors and of the District 4 and District 5 Committees, (ii) a former member of the District 3 Committee, and (iii) a Hearing Officer, conducted a Hearing in Seattle, WA, on October 18-21, 24, and 25, 2005.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Background

1. Introduction

Historically, MIS representatives recommended and sold as low risk securities the high risk securities of its affiliates, i.e., the debentures, the investment certificates, and the preferred stock (collectively the "proprietary products"). The Hearing Panel finds that this practice continued during the 21-month period from July 2001 to March 2003 referenced in the Complaint (the "Relevant Period").

Pursuant to each of the MIS supervisory manuals, the president of MIS delegated to the Firm's general manager the responsibility for the Firm's administrative and operational activities. (CX-17a, p. 5). During the Relevant Period, Respondent was listed as the Senior Vice President and General Manager of MIS. (CX-20, p. 3).

2. Issuers of the Proprietary Products—Metropolitan Mortgage and Summit

In 1953, Metropolitan Mortgage & Securities Co., Inc. ("Metropolitan Mortgage" or the "Company") was incorporated by Mr. C. Paul Sandifur, Sr., in Spokane, Washington. (CX-5, pp. 234r, 234eeee). Metropolitan Mortgage was in the business of investing in cash flow assets, i.e., assets which generate a cash flow. (CX-54oo, p. 16).

To finance its operations, Metropolitan Mortgage initially sold 10-year debentures, i.e., long-term unsecured promissory notes. (CX-12d, p. 3; Tr. p. 555). The State of Washington permitted Metropolitan Mortgage to sell its debentures intrastate, subject to certain limitations, including (i) a limit on the amount of debt the Company could issue, and (ii) a limit on the amount of an investor's total net worth that could be invested in the debentures, i.e., maximum concentration ratio.[1] (Tr. pp. 182, 641-642, 662-663).

In 1972, Metropolitan Mortgage acquired Western United Life Assurance Company ("Western United"), an insurance company that engaged in the sale of annuity contracts and invested in receivables. (CX-15h, p. 3). By 2001, Western United was Metropolitan Mortgage's largest active subsidiary. (Id.).

In 1983, Metropolitan Mortgage created MIS as a securities broker-dealer. (Tr. p. 1067). MIS conducted business as a "conduit," raising money to finance Metropolitan Mortgage's acquisition of cash flow assets. (CX-27, p. 117; Tr. p. 554).

In 1990, Metropolitan Mortgage incorporated Summit Securities, Inc. ("Summit") in Idaho, as a wholly owned subsidiary. (CX-16a, p. 3). Summit was also in the business of investing in cash flow assets.[2] (Id.). Mr. Sandifur, Jr., MIS's president, indirectly controlled Metropolitan Mortgage, Summit, Western United, and MIS. (CX-12d, p. 2). The Metropolitan Mortgage group, including Summit and Western United, engaged in the nationwide business of investing in cash flow assets, including obligations

[1] Initially, the State of Washington limited an investor to an investment of no more than 50% of the investor's net worth in the debentures, i.e., a 50% maximum concentration ratio. (Tr. pp. 182, 594).

[2] In 1994, National Summit Corporation, which was wholly owned by Mr. Sandifur, Jr., acquired Summit from Metropolitan Mortgage. (CX-16a, p. 3). In 1995, Summit acquired MIS from Metropolitan Mortgage. (Id.).

collateralized by real estate,[3] structured settlements, annuities, and lottery prizes. (CX-15h, p. 4).

In December 1999, Metropolitan Mortgage registered with the Securities and Exchange Commission a $25 million interstate note offering, which was listed on the Pacific Stock Exchange. (CX-15a, p. 64). By virtue of the stock exchange listing, the State of Washington was preempted from enforcing its limitation on the amount of debt securities that Metropolitan Mortgage could issue, but the Company, through MIS, continued to abide by its agreement to limit the amount of a customer's net worth that could be invested in the proprietary products. (RX-9, p. 1).

3. Proprietary Products

The proprietary products, which are the subject of this Complaint, consisted of Metropolitan Mortgage preferred stock and debentures, and Summit preferred stock and investment certificates. (Schedule A and Schedule B to the Complaint).

During the Relevant Period, MIS sold both Metropolitan Mortgage debentures, with varying maturities, and Series E-7 preferred stock to its retail customers. Metropolitan Mortgage had several outstanding variable cumulative preferred issues classified as Series A, Series B, Series C, Series D, Series E-1 through E-7, Series G, and Series H. (CX-15e, p. 120). The dividend rate on the outstanding preferred stock was a variable rate that adjusted monthly between a 6% minimum and a 14% maximum rate per

[3] The real estate receivables included small to mid-size commercial real estate loans, real estate contracts, and promissory notes that were secured by first position liens on residential real estate. (CX-16d, p. 3).

annum. (CX-15e, p. 15). The dividends on the preferred stock were cumulative.[4] (Id.).

The debentures, issued pursuant to the terms of a trust indenture, represented unsecured general obligations of Metropolitan Mortgage, whereby Metropolitan Mortgage agreed to pay to the owner of the debenture the face value at a future date and to pay interest at a specified rate at regular intervals. (CX-15d, p. 14).

The Metropolitan Mortgage indenture did not restrict the Company's ability to issue additional debentures or to incur other debt, including debt that was senior in right of payment to the debentures. (CX-15d, p. 15). The debentures were effectively subordinated to all indebtedness and other liabilities and commitments of Metropolitan Mortgage's subsidiaries because the Company's subsidiaries had no obligation to guarantee or otherwise pay amounts due under the debentures. (Id.). The debentures were not guaranteed or insured by another entity or any governmental agency. (Id.). The indenture did not contain restrictive covenants regarding specified financial ratios, minimum net worth, or minimum working capital. (Id.). There was no sinking fund for the redemption of the debentures. (Id.).

Summit issued preferred stock and investment certificates, which MIS also sold to the public. Similar to the Metropolitan Mortgage preferred stock, Summit issued variable rate cumulative preferred stock in series, i.e., Series S-1, S-2, S-3, R, and T.[5] (CX-16a, pp. 11-13). The Summit investment certificates represented unsecured general

[4] Cumulative means that if the stipulated dividend on preferred stock is not earned or paid in any one year (or payment period), it becomes a charge upon the surplus earnings of the next and succeeding years (or payment periods). (CX-17a, p. 30). For example, the Company could not declare or pay a dividend on a Series E-7 preferred stock unless the full cumulative dividend on all the outstanding Series C, D, and E preferred stock had been paid. (CX-15e, p. 15). All preferred stock series had liquidation preferences equal to their issue price, were non-voting, and were senior to the common shares as to dividends. (CX-15e, p. 121).

obligations of Summit and had features similar to the debentures offered by Metropolitan Mortgage.[6] (CX-16d, pp. 12-13).

4. Prior to Respondent Joining MIS

Metropolitan Mortgage and MIS had been in business for many years, and had developed a number of policies and practices that were subject to review by the State of Washington and NASD regulators. In order to evaluate Respondent's supervision of MIS, it is important to understand the nature of MIS's business in 2001 when Respondent joined.

a. <u>The Affiliated Broker-Dealer</u>

MIS became an NASD member in 1983. (CX-12d, p. 2; Stip. at ¶ 2). The Firm had one office of supervisory jurisdiction, located in Spokane, Washington, in the same building as Metropolitan Mortgage's home office. (Tr. p. 36). With the creation of MIS in 1983, the 25-30 persons working directly at Metropolitan Mortgage to sell debentures to the public became registered with NASD and began working at MIS, selling Metropolitan Mortgage debentures without significantly changing their mode of operating. (Tr. pp. 665-666, 695).

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[5] Summit could not declare or pay a dividend on a Series R preferred stock unless the full cumulative dividend on all Series S-1, S-2 and S-3 preferred stock had been paid. (CX-16a, pp. 11-13).

[6] The Summit indenture did not restrict Summit's ability to issue additional investment certificates or incur other debt, including debt that was senior in right of payment to the investment certificates. (CX-16d, p. 14). The investment certificates were not guaranteed or insured by any other entity or any governmental agency. (<u>Id.</u>). The Summit indenture did not require Summit to maintain any specified financial ratios, minimum net worth, or minimum working capital. (<u>Id.</u>). There was no sinking fund for the redemption of the investment certificates. (<u>Id.</u>). Summit's subsidiaries had no obligation to guarantee or otherwise pay amounts due under the investment certificates. (<u>Id.</u>).

In 1997, Respondent's immediate predecessor expanded the MIS work force to approximately 200 registered representatives located in seven or eight states. (CX-26, p. 73; CX-28, p. 103). All of the MIS representatives were independent contractors, and although most were located in the State of Washington, only eight of the representatives were located in MIS's Spokane, Washington office. (Tr. p. 37).

MIS had three platforms for business: (i) the proprietary products business; (ii) a direct business with mutual fund complexes; and (iii) a general securities business through a clearing firm. (Tr. pp. 155-156). The retail sales of the proprietary products that are the subject of the Complaint accounted for the majority of MIS's revenue. (CX-26, p. 56; Tr. p. 306).

b. Sales Process for the Proprietary Products

Through MIS, Metropolitan Mortgage and Summit continually offered their securities to the public. (Tr. p. 1067). When distributing its affiliates' proprietary products, MIS was subject to NASD Conduct Rule 2720, which requires, among other things, that an NASD member sell its affiliates' securities at a price no higher than the maximum public offering price, or at a yield no lower than the minimum yield, recommended by a qualified independent underwriter ("QIU").[7]

Between 1998 and 2003, Roth Capital Partners, LLC ("Roth") acted as the QIU for MIS and participated in and conducted due diligence for approximately 18 separate

[7] NASD Conduct Rule 2720(b)(15) defines a QIU as a member that: (i) is currently actively engaged in the investment banking or securities business; (ii) has been actively engaged in the investment banking or securities business for at least five years; (iii) has been actively engaged in the underwriting of public offerings of securities of a similar size and type for at least the five-year period; (iv) is not affiliated with the issuer or the beneficial owner of five percent or more of the outstanding equity or debt of the issuer; and (v) has agreed to undertake the legal responsibilities and liabilities of an underwriter as set forth under Section 11 of the Securities Act of 1933.

offerings made by Metropolitan Mortgage and Summit and their respective affiliates.[8] (RX-2, pp. 1, 5-6).

In selling the proprietary products, MIS representatives provided an offering circular to its customers and directed the customers to complete Metropolitan Mortgage or Summit subscription agreements, which were regarded as MIS account applications. (Tr. p. 59). The subscription agreements requested certain information about the customer's financial situation and needs, investment objectives, and investment experience. (CX-5, p. 176). Specifically, the customer completed a subscription agreement on which he or she: (1) listed his or her other investments; (2) indicated his or her risk tolerance as high, medium, or low; and (3) provided, in order of importance, his or her investment objectives, i.e., (a) income, (b) capital appreciation, (c) liquidity, (d) preservation of capital, or (e) other. (Id.).

The completed subscription agreement was first reviewed by MIS's processing personnel to insure adequate completion of the form, and then generally reviewed by a principal in MIS's Operations Department for suitability. (Tr. pp. 50, 97, 337). However, each of the individuals at MIS with a securities 24 license was designated as a Supervisory Principal and authorized to review subscription agreements for suitability. (Tr. p. 51).

Instead of conducting a suitability analysis for the particular customer based on the financial information set forth on the subscription agreement, the principal's

[8] On June 17, 2003, Roth sent a letter to MIS stating that it would be discontinuing its services as the QIU on the pending offerings, based on Roth's learning of the NASD investigation and the decision to raise the yield rate on certain debt securities. (RX-2, p. 5). Roth did not participate in the selling of the particular securities. (RX-2, p. 2).

suitability review focused on insuring that the customer's investment did not exceed the concentration ratios set forth in the MIS supervisory manual.[9] (Tr. p. 70). The concentration ratios were 20-30-40, i.e., a maximum 20% investment in preferred stock, a 30% investment in a single issuer (either Metropolitan Mortgage or Summit), and a 40% combined investment in multiple affiliated issuers. (Tr. pp. 48-49). Mr. Alfred Olsen, MIS's Rep Supervisor, testified "we were all told for the whole time I was there, years and years . . . , that this was a specific process, this was a specific criteria [the 20-30-40 concentration ratios] that had been approved by the NASD for these products."[10] (Tr. pp. 47-48).

c. Unsuitable Recommendations

i. Financial Condition and Risk Factors of Issuers

Beginning in 1999, the financial condition of Metropolitan Mortgage and Summit began showing signs of deteriorating.[11] For the fiscal year ended September 30, 2000, the Metropolitan Mortgage group suffered a net loss of $7.6 million and disclosed that earnings were insufficient to meet fixed charges and preferred stock dividends by $17.4 million. (CX-15a, p. 8).

A May 2001 offering document listed 10 risk factors for the Metropolitan Mortgage debentures. (CX-15a, pp. 10-12). The offering circular disclosed as a risk that

[9] Ms. Diane Edwards, MIS's Operations Manager, confirmed that "the principal would look for the concentration level." (Tr. p. 49).

[10] NASD was aware of the 20-30-40 concentration ratios and raised no objection to MIS's use of the concentration ratios. (RX-1, pp. 23-27). However, there was no evidence presented that the NASD staff knew that the Firm was using the concentration ratios in lieu of conducting a Rule 2310 suitability analysis for each customer.

[11] For the year ended September 30, 1999, the net income of the Metropolitan Mortgage consolidated group was $16,275,000, continuing a 46 year history of making money; however, for the first time, the offering documents disclosed that the Company's earnings were insufficient to meet interest payments and preferred stock dividends by $800,000. (CX-15a, p. 8).

the Company relied on its subsidiaries to make payments on the debentures. (CX-15b, p. 10). The Form 10-K annual report attached to the offering circular disclosed that (1) as of September 30, 2000, Western United Life, Metropolitan Mortgage's insurance subsidiary, held 79% of the consolidated group's assets, and (2) insurance company regulations restricted the transfer of assets and the amount of money that could be paid out in dividends by the insurance subsidiary, which could adversely effect Metropolitan Mortgage's ability to meets it debt obligations and preferred stock dividend payments. (CX-15a, p. 31). Metropolitan Mortgage's offering documents also stated that the proceeds from the offerings could be used to retire maturating investment debentures and to pay interest and dividends to prior investors.[12] (CX-15a, p. 6).

Notwithstanding their awareness of Metropolitan Mortgage's and Summit's financial conditions and the risk factors shown in the offering circulars, MIS representatives did not change their sales presentation of the proprietary products as low risk securities.

ii. MIS Customers

A number of the MIS customers had previously purchased proprietary products and, or were, second or third generation MIS customers. (Tr. p. 400). Some customers had been customers of Metropolitan Mortgage since 1950, and simply kept reinvesting in Metropolitan Mortgage products. (Id.) The customers did not know or care what type of investment it was, i.e., a debenture, preferred stock, or investment certificate. The customers only cared that the proprietary products paid their dividends or interest on

[12] Summit's offering circular explicitly stated that the consolidated group's ability to pay preferred stock dividends and to repay investment certificates, which would become due in the future, depended in part on the success of future public offerings. (CX-16a, p. 25).

time. (Tr. pp. 1077-1078). Despite the Company's extreme leverage, the customers viewed Metropolitan Mortgage as a conservative company.

iii. MIS Representatives

A number of MIS representatives also had long relationships with Metropolitan Mortgage, having joined parents who also worked in the business. (Tr. p. 106). For example, MIS representative Ryan Saccomanno joined MIS in the late 1980s through his father who began working for the MIS affiliated companies in the late 1960s or early 1970s. (Tr. p. 199). Two of Ryan Saccomanno's brothers, Randall and Ronald, were also MIS representatives.[13] (Tr. p. 201). For many MIS representatives, MIS constituted their only significant experience in the brokerage industry. (Tr. pp. 306, 617-618).

Despite knowing that Metropolitan Mortgage had never missed an interest payment on its debt instruments or a dividend payment on its preferred stock, the Hearing Panel finds that as early as 1999, MIS representatives were negligent in not realizing that the proprietary products were high risk products and were not suitable for investors who had conservative investment objectives.

5. Respondent Joins MIS

a. Respondent

Respondent initially became registered with NASD as a general securities representative in 1977 and as a general securities principal in 1985. (CX-26, pp. 10-11). In 2001, Metropolitan Mortgage recruited Respondent to work at MIS.[14] (Tr. p. 903).

[13] Members of the Saccomanno family acted as brokers for 25 of the 57 transactions listed as fraudulent on Schedule A of the Complaint. (CX-5a, p. 1-3).

[14] Immediately prior to joining MIS, Respondent was employed by Morgan Stanley DW Inc., from March 2001 to June 2001. (CX-25, p. 6). Before being employed by Morgan Stanley, Respondent had lived in Hawaii for seven years, where he ran the investment side of the First Hawaiian Bank. (Tr. pp. 903, 905).

Despite the negative financial information contained in Metropolitan Mortgage's offering circulars that he reviewed, Respondent believed the Company was in a turn-around mode. (CX-26, p. 18; Tr. p. 904).

Accordingly, on July 5, 2001, Respondent joined MIS.[15] (Tr. p. 998). Respondent reported to Mr. Sandifur, Jr., the president of both MIS and Metropolitan Mortgage. (CX-26, p. 30). Mr. Sandifur, Jr., ostensibly delegated to Respondent the day-to-day operations of MIS; however, Mr. Sandifur, Jr., significantly impacted MIS's day-to-day operations by retaining policy decision-making authority and by retaining the right to reject any of Respondent's recommendations.[16] (Tr. p. 1029).

b. MIS Management Team

When Respondent joined MIS, the management team reporting to Respondent consisted primarily of three individuals: (i) Ms. Edwards, Operations Manager; (ii) Mr. Olsen, Rep Supervisor; and (iii) Mr. Swanson, Chief Compliance Officer. (CX-17f, pp. 3-4). In 2001, Ms. Edwards was the Assistant Vice President and Operations Manager, responsible for the Firm's approval of the subscription agreements for the purchase of the proprietary products. (Tr. p. 49; CX-20, p. 1). Ms. Edwards had been with MIS for five years and was her first job in the securities industry. (Tr. p. 33).

[15] On July 12, 2001, Respondent became registered with the Firm as a general securities principal and a general securities representative. (CX-25, p. 3). On December 15, 2003, Respondent's registration was terminated; he is not currently employed by an NASD member. (CX-25, pp. 2-3). Pursuant to Article V, Section 4 of the NASD By-Laws, Respondent remains subject to the jurisdiction of NASD for purposes of the Complaint because the Complaint was filed within two years of his last association with an NASD member and the Complaint alleges misconduct while Respondent was associated with an NASD member.

[16] Mr. Sandifur, Jr., rejected a number of Respondent's recommendations, including: (i) spending money to have Standard & Poor or Moody's rate the debt; (ii) revising the investment objective and risk tolerances; and (iii) engaging in an exchange offer for the outstanding non-tradable classes of preferred stock. (Tr. pp. 907, 960). Metropolitan Mortgage also decided how many people would be hired at MIS. (Tr. pp. 196-197). Pursuant to a November 9, 2004 AWC, Mr. Sandifur, Jr., consented to a bar in all capacities. (CX-55, p. 6).

Mr. Olsen, who also had been with MIS for five years in 2001, was Assistant Vice President and Rep Supervisor. Mr. Olsen was responsible for the direct supervision of MIS registered representatives, and he assisted in the compliance department, which was "supposedly" supervised by the chief compliance officer, Mr. Swanson. (Tr. pp. 288-289, 506; CX-20, p. 3). MIS was Mr. Olsen's only securities experience.[17] (Tr. pp. 283-284). Prior to joining MIS, Mr. Olsen had spent 26 years in the U.S. Air Force in aircraft maintenance. (CX-27, pp. 6-7).

Mr. Swanson was a dual employee of Metropolitan Mortgage and MIS; he was Metropolitan's corporate secretary, and MIS's secretary-treasurer, FINOP, and Supervisory Principal.[18] (CX-17f, p. 3; CX-26, p. 43; Tr. p. 552).

c. <u>Respondent's Leadership</u>

During his tenure, Respondent took several steps to improve compliance, training, and sales, including: (1) dismissing certain MIS representatives; (2) increasing the number of compliance personnel and operations personnel; (3) instituting programs to insure the accuracy of information on the subscription agreements; (4) instituting programs to increase the MIS representatives' knowledge of the issuers' financials and the proprietary products; and (5) attempting to hire more experienced representatives.

i. Respondent's Efforts to Improve MIS's Compliance System

Shortly after joining MIS, Respondent believed that a loosely affiliated group of

[17] Mr. Olsen left MIS in July 2003. (Tr. p. 484). Pursuant to a November 9, 2004 AWC, Mr. Olsen consented to a $5,000 fine and a one year suspension in any principal capacity. (CX-57, pp. 16-17).

[18] Mr. Swanson joined Metropolitan Mortgage in 1960 and worked in the accounting area. (Tr. pp. 549-550). He became a director of Metropolitan Mortgage in 1969, was Metropolitan Mortgage's treasurer from 1972 to 1975, and received his Series 7 and Series 24 licenses in 1983 via waiver. (CX-15a, p. 80; CX-56, p. 4). In 1997, Mr. Swanson was appointed the chief compliance officer of MIS. (Tr. p. 568; CX-29, p. 18).

approximately 20 registered representatives known as the Great Northern group were engaging in sales abuses in sales of the preferred stock of Metropolitan Mortgage and Summit. (Tr. pp. 948, 982-983). The Great Northern group representatives accounted for 23% of the sales of the proprietary products. (CX-26, p. 159).

Nevertheless, after two weeks on the job, Mr. Sandifur, Jr., backed Respondent's decision to terminate the representatives in the Great Northern group. (CX-26, pp. 158-159; RX-1, p. 63). Mr. Sandifur, Jr.'s support of Respondent's decision reassured Respondent that Mr. Sandifur, Jr., was committed to compliance issues and would rely on Respondent's expertise.[19]

Respondent continued to downsize MIS because of a concern about MIS's ability to implement "far flung supervising."[20] (Tr. p. 157). Ms. Edwards described Respondent as a much more compliance-oriented and hands-on manager than his predecessor. (Id.).

In August 2001, realizing that Mr. Swanson was "chief compliance officer in name only," Respondent sought approval from Mr. Sandifur, Jr., to officially appoint Mr. Olsen as MIS's chief compliance officer. (Tr. pp. 940, 1017). Although Mr. Olsen had no outside securities experience, he was a self-starter and did a lot of reading, talking to NASD officials, and attending securities conferences about compliance issues.[21] (Tr. p. 289). At that time, however, Mr. Sandifur, Jr., did not accept the recommendation stating

[19] Subsequently, with the approval of Mr. Sandifur, Jr., the Saccomanno brothers purchased the Great Northern group's Metropolitan Mortgage book of business without consulting Respondent. (Tr. pp. 248-249, 956).

[20] During the Relevant Period, the number of MIS representatives declined from 200 to approximately 120. (Tr. p. 37). Respondent set a standard of 7-7-0 for the hiring of new representatives. (Tr. p. 980). This meant hiring an individual who had: (i) a Series 7 license (preferably with some broad experience); (ii) 7 years experience in the securities industry to give Respondent some comfort that they were well-versed in securities; and (iii) zero compliance or regulatory problems. (Id.).

[21] In 1994, Mr. Olsen obtained an undergraduate degree in business. (CX-27, p. 6). In 1997, he obtained a masters in business administration from Eastern Washington University. (Tr. p. 498).

as his reason a desire to maintain the status quo. (Tr. p. 1019).

In the spring of 2002, Respondent hired Mr. Bell as MIS's first full time auditor to routinely audit the conduct of the MIS representatives. (CX-27, pp. 54-55). No significant problems or red flags concerning the MIS representatives were brought to Respondent's attention as a result of the audits. (CX-24, pp. 19-20, 41-42, 64-65, 87-86, 93-94, 100-101). The Firm also hired two additional administrative people for the compliance department. (Tr. p. 950).

In August 2002, at the insistence of the State of Washington, Mr. Olsen officially replaced Mr. Swanson as MIS's chief compliance officer.[22] (CX-27, p. 15; Tr. pp. 309). Accordingly, Respondent charged Mr. Olsen with the responsibilities of both the Chief Compliance Officer and Rep Supervisor. Subsequently, Respondent began negotiations to hire Ms. Karen Arseneault, a former NASD employee, as MIS's Chief Compliance Officer.[23] (Tr. pp. 26, 44).

Respondent curtailed the MIS representatives' ability to change customer financial information without direct customer acknowledgment. (Tr. p. 26). MIS instituted the "contact investor" program, which was at first random but was later expanded in late 2002 to include everyone who purchased preferred stock. (Tr. pp.760-761, 984-985). Under the "contact investor" program, if a particular customer's concentration ratios exceeded 10%, 15%, or 20%, i.e., one half of the maximum 20-30-40

[22] The Securities Division of the State of Washington found that Mr. Swanson's supervision of MIS's correspondence was inadequate. (RX-1, pp. 45-53). Thereafter, in a letter dated July 29, 2002, the Securities Division of the State of Washington required the transition of the duties of the chief compliance officer from Mr. Swanson to Mr. Olsen. (RX-1, pp. 45, 53; Tr. pp. 507, 585).

[23] Ms. Arseneault accepted the position of Chief Compliance Officer at MIS after the Relevant Period. (Tr. pp. 26, 44).

concentration ratios contained in the supervisory manual, a second principal would contact the investor to confirm the investor's understanding of the product. (CX-27, pp. 158-159). In addition, prior to the completion of the purchase, a customer information audit was instituted whereby the customer would receive a form to complete that sought to confirm that the customer received a prospectus and understood the risks. (Tr. p. 985).

ii. Training

In 2001, Respondent believed that the lack of financial knowledge of the representatives was an important red flag to be addressed. (Tr. p. 982). Respondent initiated: (1) conference calls for MIS representatives to discuss the issuer's financial statements every time a 10-Q or a 10-K was released; and (2) the educational training sessions entitled Back to Basics, which focused on reading and understanding financial statements and which training was expanded to include not only new representatives but existing representatives. (Id.).

Respondent used Metropolitan Mortgage's management personnel to make the financial presentations. (Tr. p. 981). In Respondent's view, all of the prospectus risk factors became much more meaningful to the MIS representatives as a result of this training. (Tr. p. 28). However, the financial presentations continued to emphasize the excellent asset quality of the Company, with very little focus on the risks set forth in the prospectuses. (Tr. pp. 1176-1177).

Accordingly, the MIS representatives continued to believe that the Company's financial losses created only a risk that the Company would contract in size, rather than a

risk of default, and continued to personally invest in the proprietary products.[24] (Tr. pp. 513, 200, 1176-1177).

At the instigation of Metropolitan Mortgage, Respondent hired a professional pollster called Public Opinion Strategies ("POS") in 2002, based in Alexandria, VA, to gain a better understanding of the concerns and desires of MIS's customer base. (Tr. pp. 844, 920-922). POS conducted four focus groups--two customer and two non-customer groups. Based on the two customer focus groups, POS described the purchasers of the proprietary products as inexperienced investors who spent a minimal amount of time looking at or monitoring their investments. (CX-10, p. 14). POS also indicated that the average Metropolitan Mortgage customer (1) wanted a low-risk product, and (2) believed that the proprietary products were low-risk products, distinct from the stock market. (CX-26, p. 210; CX-10; Tr. pp. 985, 1031-1032, 1041).

POS presented the findings of the customer focus groups at the September 26, 2002 MIS annual meeting as a positive result rather than a false impression that needed to be corrected. (Tr. p. 130; CX-18, p. 1). In December 2002, POS followed up the focus groups with a survey of Metropolitan Mortgage customers; the POS survey reiterated that the average investor in the proprietary products wanted low risk investments and believed

[24] Ms. Edwards testified that her "distinct impression of the [C]ompany, the entire time [she] was there, was that it was a conservative company, safe." (Tr. pp. 134-135). Mr. Swanson believed that the Company's losses could be recaptured through the sales of assets that it already held. (Tr. p. 612). Ted Metoyer, an MIS representative, invested about $150,000 in the proprietary products. (Tr. p. 513). Ryan Saccomanno, an MIS representative, invested approximately 30% of his net worth in the proprietary products. (Tr. p. 200).

that the proprietary products were conservative investments.[25] (Tr. pp. 1044-1046).

iii. Supervisory Manuals

In addition to the training programs, as general manager, Respondent oversaw the revision of MIS's supervisory manuals.[26] Respondent relied on Mr. Olsen to update and revise the supervisory procedures as necessary. (Tr. pp. 976, 1016-1017).

Under Mr. Olsen's leadership, the September 7, 2001 Supervisory Manual was amended to add a section entitled "Suitability of Sales" that stated "[i]f MIS recommends to a customer the purchase of its own securities or securities of an affiliate that are underwritten by MIS, MIS must have reasonable grounds to believe that the recommendation is suitable for the customer based upon the customer's investment objectives, financial situation and needs, and other information." (CX-17c, p. 21). The above language appeared in both the October 30, 2002, and the December 10, 2002 supervisory manuals. (CX-17e, p. 21; CX-17f, p. 21).

Despite the training initiatives and the revisions to the manuals, the MIS representatives continued to believe that the proprietary products were low risk securities and continued to treat the concentration ratios, rather than the suitability factors set forth in NASD Conduct Rule 2310, as the determining factor when recommending the

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[25] By "reverse-engineering" the minimum yield recommended by the QIU and relying on both the due diligence done by the QIU and the audited financial statements, Respondent believed that the proprietary products were medium to high risk and, although not rated, were equivalent to a security rated BB, which is one step below investment grade. (Tr. pp. 908-909, 1003). In determining the equivalent rating, Respondent failed to take into account the lack of liquidity of the securities. (Tr. p. 909). Mr. Sandifur, Jr., had indicated that the proprietary products were not rated because the Company was able to raise the money that it needed to fund its operations without incurring the time and expense to obtain a rating. (Tr. pp. 761, 907). Similar information was provided to an MIS representative in an email dated April 2002. (CX-54z, p. 1).

[26] MIS had both a compliance manual and a supervisory manual. (Tr. p. 79). The compliance manual was distributed to the representatives, and the supervisory manual was designed for internal use to describe how MIS handled processes and procedures. (Id.).

proprietary products to a customer.

In late 2002, Respondent authored the Fair & Balanced Presentation standard, which emphasized the need for representatives to discuss with customers the negative risk factors as well as the positive attributes of the proprietary products. This presentation was incorporated into the Firm's compliance manual in 2003. (Tr. p. 26; CX-71g, p. 52). The section entitled "Balanced Presentation and Discussion of Risk Factors" stated explicitly "[a] balanced presentation would not favor the positive attributes of proposed investment over the potential negative attributes. . . . For example, discussing only the payment history and length of time in business of an issuer, and telling the investor to look at the prospectus themselves for the risk factors, is not a balanced presentation." (CX-17g, p. 52).

Respondent amended the January 31, 2003 Compliance Manual to state that the proprietary products, including the debt instruments, were not suitable for investors with low risk tolerances.[27] (CX-17g, p. 57; CX-28, p. 31). The Hearing Panel finds that each time the supervisory manuals were amended during the Relevant Period, they provided better supervisory procedures.[28] Accordingly, the Hearing Panel finds that the written supervisory procedures as amended by Respondent were adequate.

iv. Sales Initiatives

Despite being aware that the representatives and customers did not appreciate the

[27] Early in 2001, MIS representatives were advised that preferred stock should not be sold to customers who listed their risk tolerance as low. (CX-54c, p. 2). Prior to January 2003, Mr. Sandifur, Jr., had rejected Respondent's attempt to change the description of investment objectives from the simple "low, medium, or high" to a "more granular from a one to ten" format. (Tr. p. 419).

[28] The August 7, 2002 Compliance Manual stated "[w]hen making recommendations to clients, representatives shall have a reasonable basis to believe that such recommendations are suitable, that they are in accordance with the client's stated investment objectives, accepted risk level, and disclosed personal information and investment experience." (CX-17d, p. 24).

risks inherent in the proprietary products, Respondent instituted a number of successful sales initiatives.[29] (Tr. pp. 169-170; CX-18, p. 61). In fiscal year 2002, net new money invested in the proprietary products increased by 30% from fiscal 2001.[30] (Id.).

d. Affiliated Companies Financial Collapse

Pursuant to the AWC that MIS executed with NASD on October 16, 2003, the Firm agreed to make restitution to MIS investors involved in 163 transactions between January 2001 and March 2003.[31] (CX-12d, pp. 18-21). Respondent diligently took the necessary steps to insure that the investors set forth on the AWC received their funds. (Tr. p. 935).

On December 15, 2003, MIS ceased operations. (CX-12c, p. 32; CX-5, p. 234ggg). In press releases dated December 26, 2003, Metropolitan Mortgage and Summit advised their investors that effective December 26, 2003, dividend and interest payments would not be made.[32] (CX-5, pp. 234dddd-234ffff).

On February 4, 2004, Metropolitan Mortgage and Summit filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code, and MIS separately filed a petition for relief under Chapter 7 of the Bankruptcy Code. (CX-12c, pp. 1, 3).

Mr. Swanson anticipates that the debenture holders will recover about 30% of

[29] In January 2002, Respondent hired a National Sales Manager. (Tr. p. 1159; CX-20, p. 1). Respondent initiated the buying power report, a list of each representative's clients who, based on their concentration ratios, could be solicited to invest in more proprietary products. (Tr. p. 361). Respondent instituted sales contests to encourage the sale of the proprietary products.

[30] Net new money was money that did not involve a renewal from a previous debenture or investment certificate. (Tr. p. 730). The increase in sales included sales of shares of the initial public offering of Western United, which was also a MIS-affiliated company, but which is not the subject of this Complaint. (Tr. p. 170).

[31] Thirty-eight of the 163 transactions occurred before Respondent joined MIS on July 5, 2001. (CX-12d, pp. 18-21). The 57 transactions on Schedule A to the Complaint were included in the 163 transactions to receive restitution pursuant to the AWC. (Id.).

their investment, whereas the preferred stockholders will receive nothing.[33] (Tr. pp. 707-708).

B. Supervisory Violation Proven

1. Supervisory Rules

NASD Conduct Rule 3010(a) requires each member to establish and maintain a system to supervise the activities of each representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with NASD Rules.[34] The standard of reasonableness depends upon the facts of the case at issue. "The burden is on [Enforcement] to show that the respondent's procedures and conduct were not reasonable. It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better."[35]

Establishment of policies and procedures alone is not sufficient to discharge supervisory responsibility. A supervisor must also implement measures to monitor

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[32] After the AWC and the press releases, NASD received more than 100 customer complaints from MIS investors. (CX-12b, pp. 1-3).

[33] Respondent did not know that Metropolitan Mortgage's asset values were inflated and that losses were masked in questionable loan transactions. (Tr. p. 25).

[34] NASD Rule 3010(a) requires, among other things: (1) the designation of an appropriately registered principal with authority to carry out the supervisory responsibilities of the member for each type of business in which the broker-dealer engages; (2) the assignment of each registered person to an appropriately registered representatives and/or principal who shall be responsible for supervising that person's activities; (3) reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities; and (4) designation and identification to NASD of one or more principals who shall review the supervisory system, procedures, and inspection and take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with NASD Rules.

[35] District Bus. Conduct Comm. v. Lobb, 2000 NASD Discip. LEXIS 11, at *16 (N.A.C. Apr. 6, 2000) (citations omitted).

compliance with those policies and procedures.[36] Further, broker-dealers must "provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised."[37] A failure to supervise occurs when "red flags" are evident and are ignored, undetected, or fail to cause reasonable concern.[38]

Rule 3010(b) requires a broker-dealer to establish and maintain written procedures to supervise the types of business in which the broker-dealer engages and to supervise the activities of the registered representatives and associated persons.

Enforcement argued that (i) MIS representatives engaged in sales abuses, and (ii) Respondent as the general manager was responsible for the sales abuses. Specifically, Enforcement argued that Respondent was responsible because (i) he failed to implement adequate policies and procedures, and (ii) he failed to adequately monitor the representatives' compliance with the policies and procedures that were in place.

2. MIS Representative Sales Abuses Proven

a. Unsuitable Recommendations

After Respondent joined MIS, Metropolitan Mortgage's financial condition continued to deteriorate. For the fiscal year ended September 30, 2001, Metropolitan

[36] Thomson & McKinnon, Exchange Act Rel. No. 8,310, 43 SEC 785, 788 (1968) ("although it was registrant's stated policy . . . it failed to establish an adequate system of internal control to insure compliance with such policy"); Sutro Brothers & Co., Exchange Act Rel. No. 7,052, 41 SEC 443, 464 (1963) ("registrant did not expand its supervisory procedures to keep pace with the rapid expansion of its operations").

[37] Mabon, Nugent & Co., Exchange Act Rel. No. 19,424, 26 SEC Docket 1846, 1852 (Jan. 13, 1983).

[38] Consolidated Investment Services, Inc., Admin. Proc. File No. 3-8312, 1994 SEC LEXIS 4045, at **26-27 (Dec. 12, 1994).

Mortgage group suffered a loss of $8.9 million.[39] (CX-15k, p. 81).

Four separate offering statements for proprietary products became effective with the Securities and Exchange Commission during the tenure of Respondent, i.e., (i) two for Metropolitan Mortgage's cumulative preferred stock Series E-7, (ii) one for Metropolitan Mortgage's debentures, Series III and Series III-A, and (iii) one for Summit investment securities, Series B and Series B-1. The offering documents did not explain that, based on the risk factors and the financial condition, the proprietary securities were high risk securities and that an investor risked losing his entire investment.[40] (CX-15a, pp. 1, 10; CX-15b, pp. 1, 4; CX-15d, pp. 1, 11; CX-15e, pp. 1, 11).

Despite enhanced training with its focus on financial statements, increased audits of the MIS representatives, and the amendments to the compliance manuals, the MIS representatives continued to fail to appreciate the risks of the proprietary products. The representatives continued to recommend and sell the proprietary products as low risk securities, and they continued to treat the concentration ratios as the primary suitability standard. This was misguided because the MIS representatives should have viewed the 20-30-40 concentration ratios as an additional factor to be considered when deciding suitability not as a substitute for the factors set forth in Rule 2310.[41] (CX-28, pp. 78-79, 90). MIS supervisory principals were equally misguided. (Tr. p. 322).

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[39] For the fiscal year ended September 30, 2002, as reported on January 17, 2003, Metropolitan Mortgage reported net income of $3.92 million, which was represented as a return to profitability after two years of losses. (CX-54vv, p. 3).

[40] It was not until March 27, 2003, that Metropolitan Mortgage filed a registration statement with the Securities and Exchange Commission for Metropolitan Debentures, Series III and III-A, which explicitly stated "[t]his investment involves a significant degree of risk." (CX-15L).

[41] In a letter dated October 9, 1991, the NASD staff wrote Mr. Sandifur, Jr., president of MIS, stating that the registered representatives may not be presenting a balanced sales presentation, and as a result, certain customers may not understand the risks involved in their investment. (RX-1, p. 20). However, NASD

Accordingly, during the Relevant Period, 20 MIS registered representatives recommended in 57 instances that customers invest in excess of 20% of their net worth in the securities of Metropolitan Mortgage or Summit although the customers had listed (1) low as their risk tolerance, or (2) capital preservation as their sole investment objective on their subscription agreements.[42] (Schedule A to the Complaint).

In addition, 29 MIS registered representatives recommended in 108 instances that customers invest in excess of 20% of their net worth in the securities of Metropolitan Mortgage or Summit although the customers listed capital preservation as their number one investment objective on their subscription agreements.[43] (Schedule B to the Complaint).

Further, despite the 2001 MIS mandate that customers with capital preservation as their sole or number one investment objective not be permitted to purchase preferred stock, in 12 out of 165 transactions set forth in the Complaint, MIS principals permitted such transactions to be completed. (Tr. pp. 67, 338).

Enforcement argued that MIS representatives made (1) fraudulent sales presentations in violation of Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5[44] thereunder, and NASD Conduct Rule 2120, and (2) unsuitable

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never raised an objection to the concentration ratios adopted by MIS. (RX-1, pp. 23-27). There was no evidence that this letter was immediately presented to Respondent when he joined the Firm ten years later.

[42] The 57 transactions consisted of: (i) 30 purchases of Metropolitan Mortgage debentures; (ii) 21 purchases of Summit investment certificates; and (iii) six purchases of Summit preferred stock. (Schedule A to the Complaint).

[43] The 108 transactions consisted of: (i) 61 purchases of Metropolitan Mortgage debentures; (ii) 41 purchases of Summit investment certificates; (iii) one purchase of Summit preferred stock; and (iv) five purchases of Metropolitan Mortgage preferred stock. (Schedule B to the Complaint).

[44] 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 . . . ."

recommendations, in violation of NASD Conduct Rule 2310 and IM-2310-2.

To prove that the sales presentations were fraudulent, Enforcement had to prove that the MIS representatives made:[45] (1) misrepresentations and/or omissions in connection with the purchase or sale of securities; (2) misrepresentations and/or omissions that were material; and (3) misrepresentations and/or omissions with the requisite intent, i.e., scienter.[46] Scienter is established by a showing that a respondent acted intentionally or with severe recklessness. Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to a respondent or is so obvious that a respondent must have been aware of it.[47]

It is not disputed that the MIS representatives' sales presentations recommended the proprietary products as low risk products, which was misleading. Nevertheless, Enforcement presented no evidence that the MIS representatives, including the Saccomanno brothers, intentionally or recklessly provided the misleading information to the customers or even omitted to point out to the customers the risk factors listed in the offering documents.[48]

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

[46] See Ernst & Ernst v. Hochfelder, 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. See SEC v. Softpoint, Inc., 958 F. Supp. 846, 865 (S.D.N.Y. 1997), aff'd, 159 F.3d 1348 (2d Cir. 1998).

[47] See Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1067 (5th Cir. 1994), 1994 U.S. App. LEXIS 3326, at *14 (5th Cir. Feb. 24, 1994).

[48] The Saccomanno family personally invested more than $1,000,000 in the proprietary products. (Tr. p. 200).

Applying these standards, the Hearing Panel finds that Enforcement failed to submit evidence of scienter on the part of any particular MIS representative, and thereby failed to prove that the sales presentations amounted to fraud, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, and NASD Conduct Rule 2120.

However, Enforcement did prove that the MIS representatives violated NASD Conduct Rule 2310 and IM-2310-2 because they lacked a reasonable basis for believing that the recommended transactions were appropriate in light of the customers' investment objectives.[49] There is no scienter requirement for a Rule 2310 violation.

In most instances, the customers were unsophisticated investors who knew little or nothing about the debentures, preferred stock, or investment certificates issued by Metropolitan Mortgage and Summit, and who relied on the MIS representatives to recommend safe investments. Unfortunately, in many instances, the MIS representatives were equally unsophisticated. Consistent with the information the MIS representatives received from Metropolitan Mortgage management, and contrary to their responsibility to understand the products that they were selling, the MIS representatives failed to appreciate the significance of the risk factors set forth in the prospectuses, including the fact that the issuers' earnings were insufficient to cover the interest payments on the debt and the dividend payments on the preferred stock.

During the Relevant Period, in 165 transactions involving $4.1 million, MIS representatives recommended that the customers listed on Schedules A and B of the

[49] Wendell D. Belden, Exchange Act Rel. No. 47,859, 2003 SEC LEXIS 1154, at **10-11 (May 14, 2003).

Complaint purchase high risk proprietary products, which recommendations were not consistent with the investors' stated conservative expectations.[50]

The recommendations to purchase the proprietary products made by the MIS representatives to the customers set forth on Schedules A and B of the Complaint were unsuitable.[51] Accordingly, the Hearing Panel finds that MIS, through its representatives, violated NASD Conduct Rule 2310 and IM-2310-2.

b. False Advertisement

The Parties have stipulated that certain MIS registered representatives used misleading advertising and sales literature that violated the advertising rules during the Relevant Period. (Stip. at ¶ 6).

In 14 separate advertisements, MIS registered representatives favorably compared the rates on the proprietary products to the rates of bank certificates of deposit, without noting the difference between MIS and a bank. (CX-4, pp. 1-13). For example, an ad dated April 14, 2002, included the phrase "Tired of Low Bank Rates? Compare Our Rates." (CX-4, p. 9). Another ad dated April 8, 2002, included the phrase "Bank Rates Too Low? New One Year Rate Metropolitan Mortgage & Securities, Co., Inc. Investment Debentures, Series III." (CX-4, p. 13).

In a number of letters to potential investors, MIS registered representatives stated that there was no market volatility in the interest rates earned on the debentures, and

[50] In a few instances, MIS representatives violated the MIS supervisory procedures by recommending preferred stock to customers with either low risk tolerances or capital preservation as their sole or number one investment objective.

[51] On the NASD investor information web site, only corporate bonds of high quality with a 6% to 11% yield are considered low to medium risk investments, whereas junk bonds are considered high risk investments. (JX-1, p. 17). In addition, after the Relevant Period, at the October 2003 MIS Annual meeting, Ms. Arseneault, MIS's recently appointed chief compliance officer, told the MIS representatives

described the issuers of the proprietary products as having an unblemished 48 year history of never having missed an interest or principal payment without further describing the risks inherent in the products, especially in light of the issuers' recent financial losses.[52] (CX-4, pp. 22-38).

NASD Conduct Rule 2210 of the Advertising Rules governs the dissemination of written or electronic communications to the public and prohibits members and associated persons from making exaggerated, unwarranted or misleading statements or claims in their public communications. All public communications must be based upon the principles of fair dealing and good faith, provide a sound basis for evaluating the facts discussed, and not omit material facts or qualifications that would cause the communication to be misleading in light of its context.[53]

The Hearing Panel finds that the MIS advertising and sales literature was misleading because the ads failed to include the risks associated with the proprietary products. Accordingly, the Hearing Panel finds that certain MIS representatives violated NASD Advertising Rules 2210(d)(1)(A) and (B), 2210(d)(2)(m), and NASD Conduct Rule 2110.

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that, regardless of the agreed upon suitability guidelines, the proprietary products were junk bonds and no more than 5% of an investor's net worth should be invested in the proprietary products. (Tr. p. 217).

[52] The compliance manuals required that advertising and sales literature be approved prior to use by the compliance officer or general manager. (CX-17a, p. 11; CX-17b, p. 50; CX-17d, p.64; 17g, p. 75).

[53] In 2002, sub-part (A) of Conduct Rule 2210(d)(1) required "[a]ll member communications with the public [to] be based on principles of fair dealing and good faith and [to] provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered." It further provided that "[n]o material fact or qualification may be omitted if the omission, in light of the context of the material presented, would cause the communication to be misleading." (See NASD Notice to Members 98-83).

Sub-part (B) of Rule 2210(d)(1) prohibited members from using "exaggerated, unwarranted or misleading statements or claims" in all "public communications," and it also forbade members to "directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading." (Id.).

3. Inadequate Implementation Proven

Enforcement argued that the MIS supervisory system in place during the Relevant Period was inadequate because it failed to detect and prevent the sales practice abuses that occurred in connection with the sale of the proprietary products. Enforcement argued that Respondent was aware early on that investors did not appreciate the risks associated with the proprietary products and that Respondent should have investigated whether the investors were being misled by the Firm's representatives. (CX-26, p. 258).

The Hearing Panel finds that the sales abuses primarily occurred because the MIS representatives failed to understand, and accordingly, failed to adequately explain to their customers that the proprietary products were not low risk products.

Respondent acknowledged the inexperience of the MIS representatives early in his tenure at MIS, but he argued that he instituted the "Back to Basic" programs and the financial statement conference calls to remediate the issue. In addition, Respondent assumed that the MIS representatives were reading the prospectus and relaying the information to their clients. (Tr. pp. 1065-1066). Respondent testified that he believed that the offering documents were effectively disclosing the risk in the proprietary products because the two non-customers focus groups conducted by POS displayed a strong negative reaction to the proprietary products when shown the prospectuses.

The Hearing Panel finds that the continuing favorable response of the customer focus groups to the proprietary products, in contrast to the response of the non-customer focus groups was a red flag. Respondent should have been aware that his education initiative to ensure that MIS representatives understood and adequately explained the risks of the proprietary products to their customers was not effective. The customer focus

group continued to believe that (i) the Company was conservative, and (ii) the Company's products were low risk. Respondent should not have waited until January 2003 to take the additional step of explicitly stating that the proprietary products, including the debt instruments, were not low risk products.

Accordingly, although Respondent did not ignore any of the typical red flags of possible misconduct,[54] the Hearing Panel finds that the Respondent should have directly addressed the continuing view of the MIS representatives that the proprietary products were low risk prior to January 2003.

The Hearing Panel also noted that in addition to failing to adequately address the representatives' inaccurate view of the proprietary products as low risk, Respondent exacerbated the situation by instituting his sales initiatives, which increased rather than limited the number of investors that were ultimately harmed when Metropolitan Mortgage and Summit declared bankruptcy.

As MIS's general manager, Respondent had a duty not only to provide a meaningful supervisory structure, but also to actively monitor and enforce it.[55] When Respondent designated Mr. Olsen as MIS's Chief Compliance Officer, consistent with the State of Washington's request, he failed to relieve Mr. Olsen of the responsibility of being Rep Supervisor for more than 100 representatives. Respondent's complete delegation of both compliance and supervision responsibilities to Mr. Olsen was not

[54] Typical red flags include: (i) representatives with a number of customer complaints; (ii) representatives with regulatory histories; (iii) recently hired representatives; or (iv) representatives engaging in an unusual volume of a particular security for the firm.

[55] In re Signal Securities, Inc., Admin. Proc. File No. 10,304, 2000 SEC LEXIS 2030, at *22 (Sept. 26, 2000) (citations omitted); William H. Gerhauser, Sr., Exchange Act Rel. No. 40,639, 1998 SEC LEXIS 2402, at **17-18 (Nov. 4, 1998). (The president of a member firm "is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to

reasonable, given the limited tools Mr. Olsen had at his disposal and his inexperience. Although Respondent began the process of replacing Mr. Olsen in December 2002, Respondent should have begun the process earlier. Had someone with Ms. Arseneault's experience been hired as MIS's compliance officer earlier, it is likely that the risk and suitability issues would have been effectively highlighted for the MIS representatives before March 2003, thus limiting customer losses.

The Securities and Exchange Commission has long held that responsibility for the supervisory function of a registered broker-dealer is incumbent upon the most senior members of management, which would include a general manager.[56] There is no dispute that Mr. Sandifur, Jr., the president of MIS, hired Respondent to be the general manager.

The Hearing Panel recognizes that Respondent was faced with overwhelming compliance problems at the outset of his employment. Respondent had inadequate resources, inexperienced supervisors, and insufficient authority from Mr. Sandifur, Jr. to ensure complete compliance with the securities laws and regulations. Nevertheless, the Hearing Panel finds that, in his two and one-half year tenure at MIS, Respondent acted unreasonably in (i) failing to conspicuously disclose to the MIS representatives the risk profile of the proprietary products, in light of the captive nature of the MIS representatives and their obvious lack of true securities experience, and (ii) continuing to delegate the responsibility for both compliance and supervision of the representatives to Mr. Olsen. Accordingly, the Hearing Panel finds that Respondent violated NASD Conduct Rules 3010(a) and 2110.

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another person in that firm, and neither knows nor has reason to know that such person's performance is deficient").

[56] Frederick H. Joseph, Exchange Act Rel. No. 32,340, 54 SEC Docket 283, 290 (May 20, 1993).

III. SANCTIONS

For failure to supervise, the NASD Sanction Guidelines recommend a fine of $5,000 to $50,000, and a suspension of up to 30 business days, or, in egregious cases, two years, or a bar.[57] The Guidelines list as specific considerations in determining sanctions for failure to supervise violations: (i) whether Respondent ignored "red flags"; (ii) the nature, size, extent, and character of the underlying misconduct; and (iii) the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls.[58] The general considerations include: (i) the number, size, and character of the transactions at issue; (ii) the level of sophistication of the injured or affected customer; and (iii) whether the respondent engaged in the misconduct at issue notwithstanding prior warnings from NASD, another regulator, or a supervisor that the conduct violated NASD Rules or applicable securities laws or regulations.

Arguing that Respondent deliberately ignored a red flag, and taking into account the size and extent of the underlying misconduct, Enforcement declared that this was an egregious case and recommended that Respondent be barred in all principal capacities.

Contrary to Enforcement's argument, the Hearing Panel finds that Respondent did not deliberately ignore an indication of misconduct, which had existed for a long period of time prior to his arrival, i.e., the investors' and the MIS representatives' failure to appreciate the risks inherent in the proprietary products. Rather, the Hearing Panel finds that Respondent did not respond sufficiently to the red flag.

As the Hearing Panel noted earlier, Respondent entered a bad situation at MIS and did not immediately realize the extent of the problems. When Respondent joined

[57] NASD Sanction Guidelines, p. 108 (2006).

MIS, he realized that there were a number of supervisory issues that needed to be resolved. Respondent worked quickly to resolve what he viewed as the most glaring problems, i.e., the Great Northern group's misconduct, the need for representatives to document changes in customers' net worth or investment objectives, and the lack of true securities experience of his representatives. Respondent's actions showed a desire to do a good job, but his actions fell short.

The Hearing Panel finds that Respondent shares the liability for the supervisory violations at MIS and finds that such violations generally would warrant a significant sanction because of (i) the extent of the underlying misconduct of the MIS representatives, (ii) the injury to the customers, and (iii) the level of sophistication of the injured customers. However, the Hearing Panel also finds significant mitigation in Respondent's efforts to improve and implement compliance at MIS, including: (i) increasing the number of compliance personnel and operations personnel; (ii) instituting programs to insure the accuracy of information on the subscription agreements; (iii) instituting programs to increase MIS representatives' knowledge of the issuers' financials and the proprietary products; and (iv) overseeing the improvements incorporated into the compliance and supervisory manuals.

After weighing the aggravating and mitigating factors, the Hearing Panel determines that a six-month suspension in all capacities is an appropriate sanction. No additional monetary sanction is imposed because Respondent filed for personal bankruptcy on August 29, 2005.[59]

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[58] Id. at p. 109.

[59] On August 29, 2005, Respondent filed a petition for bankruptcy protection in the United States Bankruptcy Court for the Western District of Washington ("Bankruptcy Court"). On September 19, 2005,

IV. CONCLUSION

Respondent Ronald Pellegrino violated NASD Conduct Rules 3010(a) and 2110 by inadequately supervising MIS registered representatives. For violating NASD Conduct Rules 3010(a) and 2110, Respondent is suspended for six months in all capacities.

The sanction shall become effective on a date determined by NASD, but not sooner than thirty days from the date this Decision become the final disciplinary action of NASD, except that, if this Decision becomes the final disciplinary action of NASD, Respondent's suspension in all capacities shall commence at the opening of business on Monday, September 18, 2006, and conclude on Saturday, March 17, 2007.[60]

HEARING PANEL.

_____
Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
July 28, 2006

Copies to:
Ronald Pellegrino (via FedEx, electronic and first class mail)
David C. Utevsky, Esq. (via electronic and first class mail)
Rory C. Flynn, Esq. (via electronic and first class mail)

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the Bankruptcy Court lifted the automatic bankruptcy stay to permit this disciplinary proceeding to proceed, but the Court forbade this proceeding to impose monetary sanctions.

[60] 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.