NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant v. ROY M. STRONG (CRD No. 2340863), Respondent.	Disciplinary Proceeding No. E8A2003091501 **HEARING PANEL DECISION** Hearing Officer- Rochelle S. Hall May 18, 2007

The Respondent participated in private securities transactions without prior written notice to and written permission from his member firm, in violation of Conduct Rules 3040 and 2110. For these violations, Respondent is suspended in all capacities for one year, fined $25,000, and assessed costs.

Appearances

Richard S. Schultz and Pamela Shu, Regional Counsel, Chicago, IL, and Rory C. Flynn, NASD Chief Litigation Counsel, Washington, DC, Of Counsel, for the Department of Enforcement.

Robert L. Hartley of Locke, Reynolds, Indianapolis, IN, for Roy Strong.

DECISION

I. Procedural Background

On March 13, 2006, NASD Department of Enforcement ("Enforcement") filed its Complaint in this disciplinary proceeding. The Complaint alleges that, while associated with Intersecurities, Inc. ("Intersecurities"), Respondent engaged in private securities transactions by participating in seven sales of Charitable Gift Annuities ("CGA") to eight members of the public, without providing prior written notice to and obtaining written approval from

Intersecurities, in violation of Conduct Rules 3040 and 2110. Respondent admitted that he participated in the sale of the CGAs without obtaining written approval from Intersecurities, but denied violating the Conduct Rules, arguing that the CGAs were not securities.

On October 2, 2006, the Hearing Panel, composed of an NASD Hearing Officer, one current member and one former member of the District 4 Committee, held a hearing on this matter in Indianapolis, Indiana.[1] In addition to the testimony of Respondent, Enforcement offered the testimony of Herbert Pontzer, a former Intersecurities compliance employee; Scott M. Lenhart, Intersecurities vice president of regulatory compliance; Timothy M. Barth and Thomas E. Reece, compliance consultants who audited Strong's office; and Lisa Baird, an NASD compliance specialist. Respondent testified on his own behalf and did not offer any other witnesses. The Hearing Panel admitted fifty-six exhibits offered by Enforcement, labeled CX-1 through CX-56, CX-59, and ten joint stipulations.[2] The Parties filed post-hearing briefs on December 1, 2006.

II. Findings of Fact and Conclusions of Law

A. Jurisdiction

From July 2, 1993 to November 26, 2003, Respondent was registered as an Investment Company and Variable Contracts Products Representative with Intersecurities. He became registered as a General Securities Representative on June 13, 1996. From September 28, 2004 to date, Respondent has been registered as a General Securities Representative with CFD

[1] The hearing was reconvened and completed by telephone on November 1, 2006. "Tr." refers to the transcript of the hearing; "CX" refers to Complainant's exhibits.

[2] Statements in the Pre-Hearing Stipulations, filed by the parties on September 29, 2006, are referred to as "Stip. at ¶."

Investments, Inc.[3] Accordingly, the Hearing Panel determines that NASD has jurisdiction over Respondent.

B. Respondent Participated in the Sales of Securities Without Prior Written Notice to, and Approval of, Intersecurities

Conduct Rule 3040 requires that an associated person who intends to participate in a private securities transaction, prior to the transaction, must "provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction . . . ." Further, if the transaction is for compensation, the associated member may not engage in the transaction unless the employer gives its prior approval in writing.[4] Rule 3040 defines a "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member."

1. Respondent Participated in the Sales of CGAs Without the Prior Written Consent of Intersecurities

The Respondent stipulated that between December 31, 1996 and October 16, 2001, he participated in, and received commissions on, the following seven sales of Charitable Gift Annuities to eight customers, as alleged in the Complaint: (1) December 31, 1996, a $330,588 Mid-America Foundation ("Mid-America") CGA to R&MAG; (2) August 28, 1997, a $20,000 Mid-America CGA to R&GC; (3) June 25, 1999, a $103,947 National Heritage Foundation ("National Heritage") CGA to OL; (4) November 4, 1999, a $116,258 National Heritage CGA to

[3] Stip. at ¶1.

[4] *Alvin W. Gebhart, Jr. Se*curities Exchange Act Release No. 53,136, 2006 SEC LEXIS 93, *55, *57 (January 18, 2006).

BVM; (5) September 17, 2000, a $16,300 National Heritage CGA to MVM; (6) January 26, 2001, a $107,044 National Heritage CGA to MP; and (7) October 16, 2001, a $325,000 ABC Hollister Foundation a/k/a One Vision Children's Foundation, Inc. ("One Vision") CGA to R&MAG.[5] The total amount of sales was $1,019,137.83 and the total amount of commissions on the sales was $77,738.85.[6] The Respondent participated in these sales by presenting the CGAs to the customers for their consideration, determining that they were appropriate for the customers and acting as a witness to the documentation of the purchases.[7] The SEC has emphasized that the language in Rule 3040 prohibiting a representative from participating in securities transactions "in any manner" should be read broadly.[8] The Respondent's activities in connection with customers' CGA purchases are sufficient to constitute "participation."

The Respondent also stipulated that he participated in the sales without obtaining written or oral permission from Intersecurities.[9] Finally, the Respondent stipulated that he participated in three of the sales - of Mid-America and One Vision CGAs - without providing prior written notice to Intersecurities.[10] In his Answer, the Respondent denied that he had failed to provide prior written notice to Intersecurities of the four remaining sales; however, he did not offer any evidence at the hearing that he had given the required notices. On the contrary; the

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[5] Stip. at ¶¶ 2-8; CX 56.

[6] CX-56.

[7] CX 43, at ¶¶3, 14; Tr. at 257, 258, 264, 265-275, 283-284.

[8] *Mark H. Love*, Exchange Act Release No. 49,248, 2004 SEC LEXIS 318, *7 (February 13, 2004.)

[9] Stip. at ¶ 9.

[10] Stip. at ¶ 10.

Respondent's annual Regulatory Questionnaire and his Outside Business Activity Request Form, which the Respondent submitted to Intersecurities in 2000, failed to disclose the sales.[11]

Therefore, with respect to whether the Respondent violated Rule 3040, the only relevant issue in dispute is whether CGAs are securities.

2. The CGAs are Securities

a. The Charitable Gift Annuities

The Respondent participated in the sales to eight customers of CGAs issued by three different not-for-profit corporations—two issued by Mid-America, four issued by National Heritage and one issued by One Vision.[12] Very little in the record explains exactly how the foundations and the CGAs they issued operated—Enforcement submitted the customers' CGA applications and agreements; however, those documents contain minimal information.[13] According to the CGA applications and agreements, all of the foundations operated in essentially the same manner.

The customers, who were termed "donors," entered into contracts with the foundations whereby the customers irrevocably transferred cash, securities or other property to the foundation. The agreements were "gifts to charity," the foundations being the charities. In exchange for the gifts, the foundations agreed to make fixed annual payments to the donors for life. The CGAs were termed "annuities"; however, unlike typical annuities, neither the CGAs

[11] CX-22, CX-23.

[12] CX-56.

[13] CX-49 at p.8-25; CX-50-55.

nor the foundations were regulated by any insurance regulator and no insurance license was required to sell them.[14] Upon the deaths of the donors, any remaining principal would be distributed to the foundations or to other charities of the donors' choice. Most of the customers were in their late 70s or early 80s; however, one customer was only 51 years old.[15]

The customers were told that in addition to the annual payments, they would obtain tax benefits from the arrangement. An intangible benefit was the belief that they had made donations to charity.[16] The three foundations differed primarily in the annuity rate they offered. The Mid-America annuity rate was approximately 9.1% to 9.8%,[17] the National Heritage annuity rate ranged from 5.9% to 11.4%,[18] and the One Vision annuity rate was 11.8%.[19]

As noted, none of the CGA documents in the record mentions or describes *how* the foundations would generate income with the donations; indeed, they do not even say they would generate income. Instead, someone reading the documents would be left with the impression that the charitable foundation would simply accept the donation, make annual payments to the donor and retain whatever, if any, money remained of the donation after the donor's death—all without charging anything for this service. Two of the foundations, Mid-America and One Vision, later became involved in litigation which shed light on the true operations of the foundations.

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[14] Tr. at 303.

[15] CX-53 at 6.

[16] CX-49 at 42; CX-51 at 2; CX-55 at 3-5.

[17] CX-49 at 28; CX-50 at 4.

[18] CX-51 at 2; CX-52 at 2; CX-53 at 6; CX-53-54.

[19] CX-55 at 5.

In the case of Mid-America, an Arizona company, virtually all of the benefits claimed proved to be false and Mid-America was found to be a Ponzi scheme. *Warfield v. Alaniz,*[20] which was decided in 2006, is the only reported litigated case dealing with CGAs. The federal court in *Warfield,* in explaining how Mid-America operated, said

> Here, the investors paid money to Mid-America through an irrevocable gift of cash, securities or other assets. In return, Mid-America promised to pool the money in investments such as stocks, bonds, and money market funds, and to periodically pay each of the investors a fixed sum of money based on their individual ages and the date that payment commenced. In addition to a monthly income stream, the investors expected to receive substantial tax benefits resulting from their purchase of the CGAs…Mid-America operated solely to facilitate [the defendant]'s Ponzi scheme, and the investors were its only source of revenue. The revenue was pooled and invested in stocks, bonds, money market funds, federal obligations and other short-term and long-term investments solely for the purpose of facilitating the Ponzi scheme.[21]

Many investors lost their investments on the CGAs issued by Mid-America. However, the Respondent's two customers who owned Mid-America CGAs switched to another CGA before they lost money on the Mid-America CGAs.[22]

According to the Final Judgment entered by an Arizona State Court, One Vision was another Arizona company that, like Mid-America, had no source of revenue other than what it derived from its sales of CGAs. The Court found that One Vision pooled its investors' funds, used them to pay high commissions to agents and invested the remaining funds in high-risk enterprises. One Vision stopped making annuity payments to its "donors" and was put into

[20] *Warfield v. Alaniz, et al.* No. CV 03-2390-PHX-JAT, 2006 U.S. Dist. LEXIS 53656 (D. Ariz. August 1, 2006).

[21] *Warfield v. Alaniz, supra,* at *3.

[22] Tr. at 260.

receivership in October 2002.[23] Respondents' customers, R&MAG, lost their entire $325,000 One Vision CGA, but were reimbursed by Intersecurities.[24]

Other than the CGA applications and agreements, there is no information in the record concerning National Heritage or the CGAs it issued.

b. The CGAs are Securities under the Howey Test

The term "security" has been defined to include any "note" or "investment contract."[25] The U.S. Supreme Court in *SEC v. W. J. Howey Co.*[26] held that an investment contract involves (1) an investment of money, (2) in a common enterprise, and (3) with an expectation of profits from the management of others.[27] In the *Warfield* case, discussed above, the Court, applying the *Howey* test, held that the CGAs issued by Mid-America are securities and are not exempt from the securities laws.[28]

Adopting the analysis in the *Howey* and *Warfield* decisions, the Hearing Panel finds that the CGAs in this case are investment contracts and, therefore, securities. The Hearing Panel finds that the CGAs clearly involved an investment of money with an expectation of profits from the management of others. All of the customers listed in the Complaint invested their funds to purchase CGAs, which obligated the contracting foundations to pay a fixed monthly amount to the customers for life.

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[23] CX-38 at 27-32.

[24] CX-39.

[25] *SEC v. Edwards*, 540 U.S. 389, 393-94 (2004).

[26] *SEC v. W.J. Howey Co.* 328 U.S. 293 (1946).

[27] *Id.* at 298-299.

[28] *Warfield v. Alaniz*, No. CV 03-2390-PHX-JAT, 2006 U.S. Dist. LEXIS 53656 (D. Ariz. August 1, 2006).

The Hearing Panel rejected the Respondent's argument that the customers had not "invested" in the CGAs because the customers' primary motivation was to make charitable donations. While none of the customers testified, it seems clear that the guaranteed monthly payments for life were at least as important to them as donating to charity; otherwise they would have simply made the donation and reaped the same tax benefits. The Respondent's testimony about his customers' financial objectives belies his argument that their donative intent was paramount. One customer, RG, rejected several CGAs because they did not provide the "payout rate" that he wanted.[29] OL wanted an income stream to pay for life insurance policies on his children.[30] The Respondent testified that BVM and MVM told him, "[W]e don't want that money going to those charities; we would rather have it go in our pockets right now."[31] MP told the Respondent, "I need more income."[32] Finally, according to the CGA contracts, the customers' designated charities would receive donations only if there was any principal remaining after the lifetime annuity payments had been made.

The Hearing Panel rejected the Respondent's argument that the customers did not invest with the expectation of profits to be derived from the efforts of others. The customers made irrevocable transfers of their assets to the foundations and they were completely dependent on the foundations' efforts for their annuity payments. The *Warfield* court found that Mid-America pooled donors' funds and invested them, so that its ability to make payments to the donors depended on its success in making its own investments. Similarly, the Arizona State Court

[29] Tr. at 284.

[30] Tr. at 265.

[31] Tr. at 269.

[32] Tr. at 275.

found that One Vision pooled its donors' funds and invested in high-risk enterprises in order to make annuity payments.[33]

The Hearing Panel also finds that the Mid-America and One Vision CGAs constituted investments in a "common enterprise," since there was "horizontal commonality" among the investors. As recognized in the *Warfield* decision, "horizontal commonality" exists where multiple investors pool their funds.[34]

The Respondent argued that National Heritage did not involve a "common enterprise" because there is no evidence in the record that the customers' funds were pooled. The Hearing Panel does not find this detail to be determinative. In *SEC v. Edwards,* the U.S. Supreme Court, in interpreting the meaning of "investment contract" as defined in the *Howey* case, stated that it is "a contract or scheme for the 'placing of capital or laying out of money in a way intended to secure income or profit from its employment.'"[35] The National Heritage scheme appears to fall within this definition. Furthermore, following the analysis in *Edwards,* the SEC has stated that a "common enterprise" is not a distinct requirement for an investment contract under *Howey.*[36]

Accordingly, the Hearing Panel finds that the CGAs sold in this case are securities.

The Hearing Panel finds that Respondent violated Rule 3040 by participating in private securities transactions without providing prior notice to his firm or obtaining prior approval from

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[33] CX-38 at 27-30.

[34] *Warfield v. Alaniz, supra*, at *3, n. 5. *See Hocking v. Dubois*, 885 F.2d 1449, 1455 (9th Cir. 1989) *cert. denied* 494 U.S. 1078 (1990).

[35] *SEC v. Edwards*, 540 U.S. 389, 395, 2004 U.S. LEXIS 659, HN2 (2004).

[36] *Anthony H. Barkate* Exchange Act Release No. 49,542, 2004 SEC LEXIS 806 *11, n.13 (April 8, 2004).

his firm for the transactions. Respondent's violation of Rule 3040 is also a violation of Rule 2110.[37]

III. Sanctions

The NASD Sanction Guidelines relating to private securities transaction violations recommend a fine ranging from $5,000 to $50,000, and a suspension of up to a year, and, in cases involving sales of over $1,000,000, a 12-month suspension or bar.[38] Arguing that the Respondent participated in sales totaling over $1,000,000 and that his actions were egregious, Enforcement requested that the Respondent be barred. The Hearing Panel found that the Respondent's misconduct was not egregious and did not merit a bar. Instead, the Respondent is fined $25,000 and suspended in all capacities for one year.

The Hearing Panel determined the sanctions in accordance with the Principal Considerations for Rule 3040 violations: (1) the dollar volume of sales; (2) the number of customers; (3) the length of time over which the selling away activity occurred; (4) whether the product has been found to violate securities laws; (5) whether the Respondent had a beneficial interest in the issuer; and (6) whether the Respondent attempted to create the impression that his or her member firm sanctioned the activity.

There was no evidence that the Respondent attempted to create the impression that his firm sanctioned the sales of CGAs, other than the fact that he was associated with the firm; however, two of the sales were made to customers of the firm. While the length of time during

[37] *Sirianni v. SEC* 677 F.2d 1284, 1288 (9th Cir. 1982); *Alvin W. Gebhart, Jr.* Exchange Act Release No. 53,136, 2006 SEC LEXIS 93, n.75 (January 18, 2006); *Stephen J. Gluckman* Exchange Act Release No. 41,628, 1999 SEC LEXIS 1395, *185 (July 20, 1999).

[38] *NASD Sanction Guidelines*, p. 15 (2006).

which the sales occurred spanned almost five years, they occurred infrequently—the Respondent sold approximately one CGA per year. The number of customers was not large; the Respondent sold seven CGAs to eight customers, including one married couple.

On the negative side of the sanction determination, the record contains evidence that the Mid-America and One Vision CGAs have been found to involve violations of the securities laws. In addition, the total dollar amount of the sales is large - $1,019,137.38. This dollar amount calls for a suspension of at least one year in addition to a fine of $5,000-$50,000.

The Respondent argued that he should not be sanctioned because he did not believe the CGAs were securities. Inasmuch as the SEC has noted that scienter is not required for a finding of a Rule 3040 violation, this argument was not persuasive.[39] The Hearing Panel recognized that Intersecurities did not consider CGAs to be securities until March 2000, when it first officially notified its employees that it considered CGAs to be securities.[40] Although this was after the Respondent had sold four of the CGAs, he sold three more after he should have been aware of the requirement that he notify the firm, *and* receive permission to do so, before selling the CGAs.[41] The Respondent admitted that he had received and read an Intersecurities compliance bulletin in November or December of 2000, which notified all Intersecurities Registered Representatives that all sales of CGAs "must be approved in writing prior to engaging in them."[42]

[39] *Alvin W. Gebhart, Jr.* Exchange Act Release No. 53,136, 2006 SEC LEXIS 93, *55, *57 (Jan. 18, 2006).

[40] Tr. at 261; CX-21.

[41] *Supra* at n.38.

[42] CX-25; Tr. at 360.

The Hearing Panel concluded that the Respondent should be suspended in all capacities for one year and fined $25,000.

IV. Conclusion

Based on the evidence, the Hearing Panel finds that the Respondent violated Conduct Rules 3040 and 2110 and suspends the Respondent from associating with any member in any capacity for one year. The Respondent is also fined $25,000. The Hearing Panel also ordered the Respondent to pay the $3,940.15 cost of the Hearing, which includes an administrative fee of $750 and Hearing transcript cost of $3,190.15. The fine and costs shall be payable on a date set by NASD, but not less than 30 days after this Decision becomes NASD's final disciplinary action in this matter. If this decision becomes NASD's final disciplinary action, the suspension shall begin at the opening of business on July 16, 2007, and end at the close of business on July 15, 2008.[43]

HEARING PANEL

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By: Rochelle S. Hall
Hearing Officer

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