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**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent.

Disciplinary Proceeding
No. 2005003437102

Hearing Officer – LBB

ORDER DENYING RESPONDENT'S MOTION FOR SUMMARY DISPOSITION

On February 4, 2008, pursuant to Procedural Rule 9264, Respondent filed a motion for summary disposition seeking the dismissal of three causes of action, asserting that the subsections of NASD Conduct Rule 2830(k) on which those three causes of action are based apply only to member firms and not to persons associated with member firms. On February 28, the Department of Enforcement ("Enforcement") filed its opposition to the motion, arguing that NASD Rule 115 makes the relevant subsections of Rule 2830(k) applicable to associated persons.

Respondent seeks dismissal of the First, Second, and Third Causes of Action. The First Cause of Action charges Respondent with violating NASD Conduct Rules 2830(k)(7) and 2110 by sharing in brokerage commissions on portfolio transactions directed to Respondent's employer from a mutual fund company. The Second Cause of Action charges Respondent with violating Rule 2830(k)(4) by making an implied promise to sell the shares of the mutual fund company in exchange for directed commissions. The Third Cause of Action alleges that

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Respondent violated Conduct Rule 2110 by failing to disclose the directed commission arrangement to his clients.

For the reasons set forth below, the motion is denied.

I. Conduct Rule 2830 Applies to Persons Associated with Member Firms.

Respondent argues that the three causes of action must be dismissed because Rule 2830(k) does not apply to persons associated with member firms, but only to the firms themselves. Respondent's argument is based on a misreading of Rule 2830(a), which limits the applicability of Rule 2830 to activities in connections with investment company securities, but does not limit the persons or entities to whom the Rule is applicable. In the absence of some basis in Rule 2830(k) to exclude associated persons from its coverage, the Rule is applicable to associated persons under Rule 115.

A. Rule 115(a) Requires Associated Persons to Comply with Rule 2830.

NASD Rule 115(a) is a rule of general applicability that extends the applicability of the NASD Rules to persons associated with members. The Rule provides:

These Rules shall apply to all members and persons associated with a member. Persons associated with a member shall have the same duties and obligations as a member under these Rules.

Rule 115(a) reflects the policy expressed in the FINRA By-Laws of ensuring that persons associated with member firms conduct their business affairs ethically, in conformity with the standards of the NASD Rules.¹

¹ "To promote and enforce just and equitable principles of trade and business, to maintain high standards of commercial honor and integrity among members of the Corporation, to prevent fraudulent and manipulative acts and practices, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, to protect investors and the public interest, to collaborate with governmental and other agencies in the promotion of fair practices and the elimination of fraud, and in general to carry out the purposes of the Corporation and of the Act, the Board is hereby authorized to adopt such rules for the members and persons associated with members, and such amendments thereto as it may, from time to time, deem necessary or appropriate." FINRA By-Laws, Article XI, Sec. 1.

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The Rule has been invoked in many cases as a basis for requiring persons associated with member firms to comply with the Rules of Practice. *See, e.g., Dep't of Enforcement v. Asensio Brokerage Services, Inc.*, No. CAF030067, 2006 NASD Discip. LEXIS 20, at *40 n.25 (N.A.C. July 28, 2006) ("Pursuant to NASD Rule 115(a), rules such as Rules 2711, 2210, and 2110 that are applicable to 'members' are also applicable to persons associated with a member."); *Dep't of Enforcement v. Kaweske*, No. C07040042, 2007 NASD Discip. LEXIS 5, at *14 n.8 (N.A.C. Feb. 12, 2007) ("A violation of another Commission or NASD rule, including Exchange Act Section 10(b) and SEC Rules 10b-9, 15c2-4, and 10b-5, is also a violation of NASD Conduct Rule 2110.... In addition, NASD Conduct Rule 115 makes all NASD rules, including Conduct Rule 2110, applicable to both NASD members and all persons associated with NASD members.") (citation omitted); *Dep't of Enforcement v. Block*, No. C05990026, 2001 NASD Discip. LEXIS 35, at *15 n.15 (N.A.C. Aug. 16, 2001) (finding violations of Rules 2110, 2120, and 3110).²

To the extent that there is any ambiguity in whether Rule 2830 is uniquely inapplicable to associated persons, the Rule should be interpreted to comport with the overall intent of the rules. Rule 113 provides a general guide for the interpretation of the Rules of Practice:

The Rules shall be interpreted in such manner as will aid in effectuating the purposes and business of the Association, and so as to require that all practices in connection with the investment banking and securities business shall be just, reasonable and not unfairly discriminatory.

An interpretation of Rule 2830 that permits individuals to escape liability for violations of Rule 2830 would be inconsistent with the interpretive requirement of Rule 113. Rule 2830 is intended to protect investors in investment company securities, and exempting individuals from

² *D.B.C.C. v. Podesta & Co.*, 1998 NASD Discip. LEXIS 27 (N.A.C. Mar. 23, 1998), cited by Respondent, does not support Respondent's motion. That case was decided under a specific rule of the MSRB that was expressly inapplicable to associated persons. Furthermore, under NASD Rule 114, the NASD Rules are inapplicable to transactions in municipal securities.

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responsibility for compliance would substantially reduce the effectiveness of the Rule. As discussed below, violating the requirements of Rule 2830(k), in particular, was found by the Board of Governors to be "inconsistent with just and equitable principles of trade." It would be inconsistent with this finding to give associated persons a blanket exemption from the requirements of the Rule.

Pursuant to Rule 115(a), Rule 2830 applies to persons associated with members unless the Rule explicitly provides that it does not.

B. The text of Rule 2830 is inconsistent with an intent to restrict the applicability of the Rule only to member firms and not persons associated with member firms.

The parties agree that the first line of inquiry should be an analysis of the language of the Rule, but disagree about what the Rule says. *See Dep't of Enforcement v. Respondent Firm, Frank J. Skelly, III, Craig H. Gross and Respondent 3*, No. CAF000013, 2003 NASD Discip. LEXIS 40, at *14 (N.A.C. Nov. 14, 2003). The language of the entire Rule is inconsistent with an intent to limit the applicability to member firms and to exclude application of the Rule to persons associated with member firms. Because Rule 2830(a) applies to all of Rule 2830, the effect of reading that section in the manner suggested by Respondent would require that the entire Rule apply only to firms.

Rule 2830(a) states that Rule 2830 "shall apply exclusively to members in connection with the securities of companies registered under the Investment Company Act of 1940" Respondent contends that the word "exclusively" is meant to limit to whom the Rule is applicable, i.e., that the Rule applies "exclusively to members." Enforcement contends that the word "exclusively" in Rule 2830 is intended to apply to the types of securities covered by the Rule, i.e., that the Rule applies "exclusively ... in connection with the securities of companies registered under the Investment Company Act of 1940"

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Respondent's interpretation is contrary to the language of various provisions of the rule, which explicitly impose certain obligations and prohibitions on associated persons, as well as on members. If Respondent's reading of 2830(a) were correct, it would nullify those provisions. On the other hand, Enforcement's interpretation of 2830(a) is fully consistent with all the provisions of the rule, because on their face they all pertain to Investment Company securities. Respondent, therefore, has failed to establish that Rule 2830 is an exception to Rule 115(a).

Several subsections of Rule 2830(d), relating to sales charges for the sale of investment company securities, explicitly apply to associated persons: Rule 2830(d)(4) prohibits member firms and associated persons from making certain representations relating to whether an investment company is a "no load" fund or has no sales charge; Rule 2830(d)(5) prohibits member firms and associated persons from offering or selling investment company securities if the service fees exceed a specified level; and Rule 2830(d)(6) prohibits member firms and associated persons from offering or selling investment company securities with a deferred sales charge under certain conditions. Although entitled "Member Compensation," certain subsections of Rule 2830(l) also explicitly apply to any "person associated with a member." *See* Rule 2830(l)(1), (2), and (5).³

If Respondent's interpretation of the language of Rule 2830 were accepted, the subsections that explicitly apply to persons associated with member firms would be inconsistent with Rule 2830(a). A more sensible reading would interpret the word "exclusively" as limiting the nature of the securities to which the Rule is applicable, but not restricting the identity of those to whom the Rule is applicable.

³ Respondent is charged with violating Rule 2830(l) in the Fourth Cause of Action in the Complaint. This brief discussion of the text of the Rule is not intended to express any conclusions about the Fourth Cause of Action, either factually or as a matter of law.

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II. Respondent's motion is denied with respect to the First Cause of Action pursuant to Rule 2110.

The First Cause of Action of the Complaint alleges that Respondent violated Conduct Rules 2830(k)(7)(C) and 2110 by sharing in directed brokerage that was paid to his member firm, allegedly with the understanding that the funds were to be passed on to Respondent. The motion is denied with respect to the First Cause of Action because Respondent has not shown that the Complaint fails to state a cause of action under NASD Conduct Rule 2110. Because the First Cause of Action is pled under both Rules 2110 and Rule 2830(k)(7)(C), it is unnecessary to decide whether the conduct alleged in the First Cause of Action would, if proven, violate Rule 2830(k)(7)(C).

Although Respondent has not moved to dismiss the claim in the First Cause of Action that sharing in directed brokerage commissions is a violation of Rule 2110, he argues with respect to the Third Cause of Action that Rule 2110 has no independent significance, and is merely a "piggyback" rule. Respondent presumably contends that the same argument applies to the First Cause of Action. Respondent misunderstands Rule 2110. NASD Conduct Rule 2110 is an independent requirement applicable to all members and persons associated with members.⁴ Like their member firms, associated persons are required to "observe high standards of commercial honor and just and equitable principles of trade" in the conduct of their business. The Rule applies both to conduct that violates other rules as well as conduct that is unethical but may not violate any other specific rule.

In *Dep't of Enforcement v. Shvarts*, the National Adjudicatory Council (NAC) explained the reach of Rule 2110:

⁴ Conduct Rule 2110 is applicable to an associated person pursuant to Rule 115(a). *Kaweske*, 2007 NASD Discip. LEXIS 5, at *14 n.8; *Dep't of Enforcement v. Gerace*, No. C02990022, 2001 NASD Discip. LEXIS 5, at *8, n.8 (N.A.C. May 16, 2001).

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Conduct Rule 2110 "is not limited to rules of legal conduct but rather ... it states a broad ethical principle." ... Disciplinary hearings under Conduct Rule 2110 are ethical proceedings, and one may find a violation of the ethical requirements where no legally cognizable wrong occurred. ... The NASD has authority to impose sanctions for violations of "moral standards" even if there was no "unlawful" conduct.

2000 NASD Discip. LEXIS 6, at *11 (June 2, 2000) (citations and footnote omitted). The NAC further explained:

In the caselaw developed under the rule, some types of misconduct, such as violations of federal securities laws and NASD Conduct Rules, are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations. ... Other types of violations, such as failures to honor obligations imposed by private contracts, are viewed as violations of Conduct Rule 2110 only if the surrounding facts and circumstances indicate that the conduct was unethical. The concepts of excuse, justification, and "bad faith" may be employed to determine whether conduct is unethical in these cases.

Id. at *12-13.

The NAC recently explained in holding that a Registered Representative violated Rule 2110 by making misrepresentations to his employer concerning loans from firm customers:

The SEC has construed Conduct Rule 2110 broadly to apply to all business-related misconduct.... The principal consideration is whether the misconduct reflects on an associated person's ability to comply with regulatory requirements necessary to the proper functioning of the securities industry and protection of the public....

Dep't of Enforcement v. Davenport, No. C05010017, 2003 NASD Discip. LEXIS 4, at *8-9 (May 7, 2003); *see also Dep't of Enforcement vs. Taylor*, No. C8A050027, 2007 NASD Discip. LEXIS 11, at *22 (N.A.C. Feb. 27, 2007) (falsification of document submitted to state insurance authorities); *Daniel D. Manoff*, Exchange Act Rel. No. 46708, 2002 SEC LEXIS 2684, at *11-12 (Oct. 23, 2002) (unauthorized use of co-worker's credit card numbers).

The Board of Governors, in its interpretation of the predecessor to Rule 2830(k) under the Rules of Fair Practice, specifically stated that the conduct proscribed by Rule 2830(k)(7)(C)

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“shall be deemed conduct inconsistent with just and equitable principles of trade....” NTM 73-42, 1973 NASD LEXIS 46, at *12 (May 25, 1973). The Rule is thus not a mere mechanical rule; it also embodies ethical principles. Receipt of funds to which a person is not entitled may be unethical even if it is not specifically covered by a rule. *Cf. Dep't of Enforcement v. Farley*, No. C9A000038, 2001 NASD Discip. LEXIS 51, at *10-11 (O.H.O. Oct. 2, 2001) (unethical conduct in violation of Rule 2110 to keep and spend firm funds that another person had improperly deposited in Respondent's account).

As noted above, it is unnecessary to decide if the conduct alleged in the First Cause of Action would violate Rule 2830(k)(7)(C), which prohibits member firms, and therefore persons associated with member firms, from granting to sales personnel any participation in directed commissions. It is not clear that Enforcement has adequately pled a violation of the rule, which appears to prohibit only the grant, but not the receipt, of the prohibited commissions. In arguing that the Rule does apply, Enforcement relies on a 1984 Notice to Members that reminded members that Rule 2830 prohibits allowing registered representatives to share in portfolio brokerage commissions under certain circumstances. To “allow” sales personnel to share in the commissions is equivalent to a “grant” of such commissions to such persons. The Notice focuses on the conduct of the member, and provides no support for an interpretation of Rule 2830(k)(7)(C) that appears to be inconsistent with the plain text of the Rule.

By holding that Rule 2110 may apply to Respondent's conduct, this Order does not suggest that it applies as a mirror image of Rule 2830(k)(7)(C).⁵ Neither party has addressed the issue of the standards to be applied to determine if Respondent's conduct may violate Rule 2110

⁵ Respondent has argued that he cannot be charged with a violation of Rule 2830(7)(C) because “the rule failed to give fair notice that [Respondent]'s alleged practices were prohibited.” See Motion at fn.7. Such a defense has been recognized for a different section of Rule 2830. See *Dep't of Enforcement v. Respondent*, E8A2003062001 (O.H.O. June 28, 2007) (available at www.finra.org/OHO). Respondent has not made a similar argument about whether he may be held to have violated Conduct Rule 2110, and the question may depend on the facts of the case.

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in the absence of a finding that it violated Rule 2830(k)(7)(C). The Hearing Panel will determine if Rule 2110 has been violated after considering the submissions of the parties on the legal standards to be applied, as well as the evidence and arguments presented at the hearing.

III. Respondent's motion is denied with respect to the Second Cause of Action under Rule 2830(k)(4).

Respondent moves for summary disposition on the Second Cause of Action, charging him with violating Rule 2830(k)(4) when he allegedly "arranged to receive directed commissions in order to hire a sales assistant, formerly employed by Fund Company, with the intent of generating new sales of Fund Company securities. In these circumstances, Respondent made an implied promise to sell Fund Company securities in exchange for the directed commissions."

Rule 2830(k)(4) provides:

[N]o member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

Respondent argues that Rule 2830(k)(4) does not apply to him because he is an associated person, but not a member of FINRA. As discussed above, Rule 115 applies to claims under Rule 2830.

The motion is denied with respect to the Second Cause of Action solely for the reason that Rule 2830(k)(4) is applicable to persons associated with member firms, pursuant to Rule 115. By denying the motion, no opinion is expressed as to whether Respondent has violated Rule 2830(k)(4), or as to the standards to be applied in determining whether Respondent has violated that Rule. As with the First Cause of Action, that determination awaits the submissions of the parties and the evidence and arguments presented at the hearing.

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IV. Respondent's motion is denied with respect to the Third Cause of Action under Rule 2110.

Respondent moves for summary disposition with respect to the Third Cause of Action, charging him with misleading omissions and representations in violation of Rule 2110.

Respondent argues that the Third Cause of Action should be dismissed because it is "it is completely derivative of the claims that are barred by Rule 2830(k)." Respondent contends that Rule 2110 has no independent significance, and that the dismissal of the charges under Rule 2830 requires the dismissal of the charges under Rule 2110. Respondent misunderstands the scope of Rule 2110 with respect to the Third Cause of Action. The Rule prohibits misrepresentations and omissions, and its applicability does not depend on a finding that Rule 2830(k) is applicable to Respondent's conduct.

"Misrepresentations and omissions also are inconsistent with just and equitable principles of trade and therefore are a violation of NASD Conduct Rule 2110." *Dep't of Enforcement v. Meyers*, No. C3A040023, 2007 NASD Discip. LEXIS 4, at *18 n.6 (N.A.C. Jan. 23, 2007). A negligent misrepresentation that does not rise to the level of fraud may nevertheless violate Rule 2110. *Dep't of Enforcement v. Kelsey*, No. C8A020088, 2004 NASD Discip. LEXIS 48, at *26-27 (O.H.O. June 29, 2004); *Robert Tretiak*, Exchange Act Rel. No. 47534, 2003 SEC LEXIS 653, at *21 n.21 (Mar. 19, 2003) ("Scienter is not required to prove the violation of Rule 2110.").

The Complaint alleges that Respondent deceived his customers concerning his arrangement with the mutual fund company by failing to disclose the arrangement and misleading his customers concerning the arrangement. Respondent has not, for purposes of this motion, contested the allegation. The allegation states a separate, independent violation of Rule 2110, and does not require that Enforcement prove that the arrangement violated Rule 2830(k). The motion is denied with respect to the Third Cause of Action.

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Conclusion

For the reasons set forth above, Respondent's motion for summary disposition is denied in its entirety.

SO ORDERED.

Lawrence B. Bernard
Hearing Officer

Dated: April 4, 2008
Washington, DC