FINANCIAL INDUSTRY REGULATORY AUTHORITY[1]
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. GERALD J. KESNER (CRD No. 2337113), Respondent.	Disciplinary Proceeding No. 2005001729501 **Hearing Panel Decision** Hearing Officer – SW Dated: August 15, 2008

The Hearing Panel bars Respondent from associating with any FINRA member in any capacity for violating: (1) NASD Conduct Rules 2310 and 2110, as set forth in count one of the Complaint; and (2) Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110, as set forth in count two of the Complaint.

Appearances

Helen G. Barnhill, Esq., Regional Counsel, Denver, CO, and Jacqueline D. Whelan, Esq., Senior Counsel, San Francisco, CA, for the Department of Enforcement.

Martin M. Berliner, Esq., Greenwood Village, CO, for Respondent Gerald J. Kesner.

I. PROCEDURAL HISTORY

A. Complaint and Answer

On March 30, 2007, the Department of Enforcement ("Enforcement") filed a two-count Complaint against Respondent Gerald J. Kesner ("Respondent") regarding his soliciting investors to acquire the stock of ComTec Teleservices, Inc., and the

[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References

membership interests of ComTec Services, LLC (collectively, "ComTec" or the "Company").[2]

Count one of the Complaint alleges that Respondent violated NASD Conduct Rules 2310 and 2110, by making an unsuitable recommendation that customers ML and his spouse CL (collectively, the "Customers") purchase the stock of ComTec with other investors by pledging the equity in their home and one of their securities accounts as collateral to finance the acquisition.

Count two of the Complaint alleges that Respondent violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110, by recommending the purchase of ComTec without disclosing to the Customers and the other members of the investor group certain material information regarding the purchase.

Respondent denied the allegations. Specifically, Respondent denied that the ComTec purchase was an unsuitable recommendation for the Customers, and denied that he fraudulently withheld material information about the ComTec purchase from the Customers or other members of the investor group.

B. Hearing

The Hearing Panel, consisting of two current members of the District 3 Committee and a Hearing Officer, conducted a Hearing in Denver, CO, from January 28

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in this decision to FINRA include, where appropriate, NASD.

[2] On March 31, 2001, ComTec switched from a C corporation to a limited liability company, *i.e.*, ComTec Services, LLC. (RX-5, p. 2). New business was placed in the limited liability corporation, whereas existing business was handled under the C corporation, *i.e.*, ComTec Teleservices, Inc. (*Id*.).

to February 1, 2008.[3]

Based on the evidence adduced at the Hearing, the Hearing Panel finds that Enforcement met its burden of showing by a preponderance of the evidence that the ComTec transaction was unsuitable for the Customers, and that Respondent fraudulently withheld material information about the ComTec transaction from the Customers and the other investors.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Facts

1. Jurisdiction

Respondent entered the securities industry in April 1993 and became registered as a general securities representative with member firm Raymond James Financial Services, Inc. ("Raymond James" or the "Firm") in June 1998. (Tr. p. 1224). Respondent remains associated with Raymond James. (Tr. p. 334).

While registered with Raymond James, Respondent was also employed as an investment advisor with a registered investment advisory company, Capital Financial Group, Inc. ("CFG"). (Tr. pp. 334, 1269).

2. ComTec Acquisition

In July 2001, Mr. and Mrs. H, the owners of ComTec (the "Sellers"), suggested that Respondent form an investor group to purchase ComTec.[4] (Tr. pp. 726-727). ComTec provided call center functions for large companies, *i.e*., handling inbound calls as well as outbound marketing calls and other customer retention functions. (RX-5, p. 1).

[3] "Tr." refers to the transcript of the Hearing held from January 28 to February 1, 2008; "CX" refers to the exhibits submitted by Enforcement; and "RX" refers to the exhibits submitted by Respondent.

[4] The Sellers had been Respondent's brokerage clients since 1995. (Tr. pp. 719-720).

Respondent initially approached (i) Mr. Leonida, his employer at CFG, (ii) the Customers, and (iii) another client, PF and his spouse DF (the "PF Couple"), to purchase ComTec.[5] (Tr. pp. 339-340). Ultimately, Respondent formed an investor group composed of five married couples, including the Customers, the PF Couple, and Respondent and his spouse. (Tr. p. 361). The arrangement was always that Respondent would be the majority shareholder of the investor group. (Tr. p. 739). In July 2001, Respondent sought approval for his participation in the investor group from Raymond James, which approved the transaction as an outside business activity.[6] (CX-3).

Respondent advised the investors that the total purchase price for the Company was $5 million, which was consistent with the $4-5 million valuation of the Company prepared by Respondent in 2000 at the Sellers' request.[7] (Tr. pp. 339-341, 723-724; CX-2, p. 1). Respondent arranged the transaction, including a bank loan, and controlled the information flowing to and from and among the investors. (CX-2, p. 3; Tr. pp. 221, 353-354).

Respondent knew but did not disclose to the other investors that in July 2001 the Sellers paid $100,000 to an individual to relinquish his right to receive 25% of the

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[5] The investors originally expected the loan and the purchase to close in October 2001. (Tr. pp. 345, 455-456).

[6] In 2007, Raymond James entered into an Acceptance, Waiver and Consent agreement with FINRA, pursuant to which Raymond James was sanctioned for failing to treat Respondent's participation in the investor group as a private securities transaction, and failing to supervise Respondent's participation in the transaction, as required by Rule 3040. (CX-5, pp. 3-4).

[7] Respondent was a chartered financial analyst. (Tr. pp. 335, 806). Respondent's valuation of ComTec was based on cash flow, discounted cash flow, book value, and future growth using a valuation module included in CFG's financial planning software suite. (Tr. pp. 723, 979).

proceeds of any sale of the Company.[8] (Tr. pp. 118, 594; CX-6, pp. 3-4). If disclosed, the willingness of a former company insider to accept merely $100,000 for the right to receive 25% of the sales proceeds may have suggested to the investors that the Company was worth substantially less than the $5 million purchase price.[9]

Colorado Business Bank ("Colorado Bank" or the "Bank") agreed to provide the only outside funding for the purchase, a loan in the principal amount of $2.5 million ("CBB Loan"). (Tr. p. 354). In early 2002, Colorado Bank advised Respondent that, as a condition of the CBB Loan, it would require that the investors pay $500,000 toward the purchase price. (CX-2, p. 2). To convince the Bank that he could fulfill this condition, Respondent obtained a $500,000 loan from the Sellers, deposited the funds in his personal bank account, and prior to the closing submitted a February 2002 bank statement to Colorado Bank to verify that he had $500,000.[10] (Tr. pp. 426, 776).

Respondent did not disclose to Colorado Bank that he had obtained the funds from the Sellers and would be repaying the loan at the closing, and he did not disclose to the investors that: (i) he was circumventing the Bank's requirement of a $500,000 cash

[8] The Sellers purchased the Denver, CO, office of a New Jersey call center company in 1996, which became known as ComTec. (Tr. pp. 720, 722). In 1998, the Sellers entered into an agreement with Mr. C, chief executive officer of the New Jersey call center company, which agreement included a payment clause in the event of ComTec's future sale. (CX-6, p. 3). On November 27, 2000, Mr. H offered to pay $50,000 to Mr. C to eliminate the payment clause of the agreement. (*Id.*). Ultimately, Mr. C agreed to accept $100,000. (*Id.*).

[9] In fact, the investors believed that the Company was worth more than $5 million because Respondent shared with them an oral report, prepared by a call center consultant based in Scotland, valuing the Company at $6 to $10 million (Tr. pp. 724-725). Respondent told the investors and testified that Mr. H said "I would be more interested in selling [ComTec] to someone that I trust and taking a lower price than I would be in getting top dollar from someone that wasn't going to look after the existing employees and the existing operations." (Tr. pp. 51, 53, 631, 727).

[10] Respondent executed a promissory note for $500,000 on January 17, 2002, which provided for repayment to the Sellers on the date of the closing. (RX-6; Tr. pp. 776-777). Respondent deposited the funds into his personal account at USBank, rather than in his primary bank account at Raymond James. (RX-7; Tr. pp. 426, 994-995).

investment; (ii) he had obtained a loan from the Sellers to meet the Bank's requirement; or (iii) he planned to repay the Sellers' loan at the closing. (Tr. pp. 781-782, 840; CX-20, pp. 8-9, 11 at subpages 111-112, 114). Disclosure of the Bank's requirement, Respondent's actions to circumvent that requirement, and the Sellers' willingness to loan $500,000 to ensure completion of the transaction might have suggested to the investors that the purchase was not as attractive an opportunity as Respondent suggested.

The Bank also required as a condition of the loan that the investors jointly and severally guarantee the full amount of the CBB Loan. (RX-16; RX-17; Tr. pp. 355, 1221). The investors agreed to do this, but entered into a hold-harmless agreement ("Hold Harmless Agreement") among themselves to allocate the default risk in a manner that, except for Respondent and his spouse, was roughly equivalent to their ownership interests. (RX-2; Tr. pp. 386, 752-753).

According to the Hold Harmless Agreement, to the extent there was a default on the $2.5 CBB Loan: (i) the PF Couple[11] would be responsible for $1 million; (ii) SG and his spouse (the "SG Couple") would be responsible for $400,000; (iii) MN and his spouse DN (the "MN Couple") would be responsible for $200,000; (iv) the Customers would be responsible for $400,000; and (v) Respondent and his spouse would be responsible for any debt above $2 million. (RX-2, p. 3).

Having reviewed the financial statements of each member of the investor group, Respondent explicitly represented to the Customers that each of the investors had

[11] On March 6, 2002, after Mr. Leonida withdrew from the transaction, the PF Couple agreed to increase their potential obligation to $1 million. (Tr. pp. 790, 887-888, 1291). Based on the August 14, 2001 financial statement that the PF Couple provided to Colorado Bank, the PF Couple's net worth was $851,000. (RX-5, p. 26).

sufficient assets to meet their obligations under the Hold Harmless Agreement in the unlikely event that ComTec defaulted on the CBB Loan. (Tr. p. 400).

The Bank also required the investors to provide collateral to secure the loan. Other than Respondent, none of the investors knew the form of collateral or the specific value of the collateral that was contributed by any other investor. (Tr. pp. 97, 1249). To collateralize their pro rata share of the CBB Loan, the Customers pledged their home and one of their several Raymond James securities accounts.[12] (RX-17). Respondent did not disclose to the Customers that the other investors pledged only real estate. (RX-5, p. 25). Furthermore, based on the Bank's valuation, the real estate pledged by the PF Couple was not adequate to cover their obligation under the Hold Harmless Agreement.[13] (*Id.*). At the Hearing, Respondent admitted that he knew that the PF Couple's collateral, as valued by the Bank, was insufficient to cover their potential obligation under the Hold Harmless Agreement. (Tr. pp. 790, 888).

Respondent failed to disclose to the Customers that: (i) they had pledged a disproportionate amount of the total collateral for the loan;[14] (ii) they had pledged the

[12] When the Customers initially pledged their Raymond James securities account at the end of February 2002, its value was approximately $595,000. (CX-25, p. 1). By the end of March 2002, however, the net value of the pledged account had increased to approximately $837,000 because Respondent transferred assets from two of the Customers' other Raymond James accounts into the pledged account on March 19, 2002, prior to the closing. (CX-25, pp. 7, 11-13; CX-32). The Customers were prohibited from withdrawing cash or securities from the pledged account without the express approval of an officer of the lending bank. (CX-26).

[13] Colorado Bank valued the PF Couple's property at $469,000 in October 2001. (RX-5, p. 16). Although a February 2002 appraisal valued the PF Couple's residence at $1.13 million, the Bank continued to value the property at $469,000 for purposes of collateral. (RX-5, p. 25). In addition to their residence, however, the PF Couple also pledged undeveloped real estate located next to their residence, to which the Bank assigned an additional $180,000 net value, for a total collateral value of $649,000. (*Id*.).

[14] The SG Couple provided collateral valued by the Bank at $458,000 ($342,000 on the house and $116,000 on a vacation home) to meet their $400,000 obligation, and the MN Couple provided $232,000 (the value of their house) to meet their $200,000 obligation. (RX-5, p. 25).

only liquid collateral; and (iii) under the Bank's valuation, the PF Couple lacked sufficient assets to meet their potential $1 million obligation under the Hold Harmless Agreement. If disclosed, these facts might have indicated to the Customers that, in the event of a default on the CBB Loan, their potential liability could be significantly greater than the amount reflected in the Hold Harmless Agreement.[15]

On April 3, 2002, the investor group executed the Purchase and Sale Agreement ("Purchase Agreement") to acquire ComTec. (RX-9). The transaction was structured such that the Sellers sold approximately 5,000 shares of ComTec's outstanding common stock for $2 million (4,950 shares were sold to ComTec for $1.8 million and 50 shares were sold to the investor group for $200,000).[16] (RX-9, pp. 1-3 at Sections 1.1.1 and 1.2.1).

The Purchase Agreement explicitly provided that "[i]n addition to all other amounts payable under this Agreement, at the Closing [Respondent] shall pay to [the Sellers], the sum of Five Hundred Thousand Dollars ($500,000) in cash by cashier's check." (RX-9, p. 3 at Section 1.2.2). The Purchase Agreement did not, however, disclose that this payment was in satisfaction of the Sellers' loan to Respondent, rather

[15] The Customers provided collateral valued by the Bank at $984,000 ($320,000 on their house and $664,000 in their Raymond James account) to meet their $400,000 obligation, while the PF Couple provided just $649,000 ($469,000 on their house and $180,000 on raw land) to meet their $1 million obligation. (RX-5, p. 25). The Bank discounted the securities and the real estate of the investors using a set formula. (*Id.*).

[16] Concurrent with the Purchase Agreement, ComTec and the investor group, ComTec's new shareholders, entered into a second agreement for ComTec to purchase the Sellers' LLC membership interests ("LLC Agreement"). (RX-9, p. 6). Pursuant to the LLC Agreement, ComTec paid the Sellers $2.5 million ($1 million in cash and a $1.5 million promissory note) for their membership interests. (CX-12, pp. 2-3 at Section 1.1.1). The $1.5 million promissory note was secured by the outstanding stock of ComTec acquired by the investor group, and guaranteed by Respondent personally in the form of a promissory note guarantee. (CX-12, pp. 3-4).

than a payment by Respondent toward the purchase price.[17] (RX-9).

The transaction closed in accordance with the Purchase Agreement. Based, in part, on their obligations with respect to the CBB Loan under the Hold Harmless Agreement: (i) the PF Couple received 20% of the 50 outstanding shares of ComTec; (ii) the SG Couple received 9%; (iii) the Customers received 9%; (iv) the MN Couple received 5%; and (v) Respondent and his spouse received 57%. (Tr. p. 98; RX-9, pp. 2-3).

3. ComTec's Demise

Within seven months after the closing, the Company began to fail.[18] (Tr. pp. 854-855, 1153; CX-9, p. 2 at ¶ 16). Each of the investors began making pro-rata contributions to the principal payments on the CBB Loan to keep it current.[19] (Tr. p. 158). On April 1, 2004, the Company ceased operations. (Tr. p. 856).

Subsequently, the PF Couple deserted their pledged property without notifying any of the other investors.[20] (Tr. p. 857; CX-9, p. 4 at ¶ 28). To avoid having their homes and securities seized by Colorado Bank, the Customers and the remaining members of the investor group, the SG Couple and the MN Couple: (i) formed a limited liability

[17] There was no discussion at the closing about the $500,000 check delivered to the Sellers. (Tr. p. 783). The Sellers were to receive the $500,000 as a deferred payment rather than as an up front cash payment. (Tr. pp. 1161-1162).

[18] In November 2002, ComTec's largest client gave notice that it was terminating its business relationship with ComTec because it decided to bring its call center service in-house. (Tr. pp. 854-855, 1153; CX-9, p. 2 at ¶ 16). In a letter dated October 18, 2004, Mr. H wrote that he told Respondent that ComTec did not have any long-term agreements with clients and that it had been ComTec's history to operate on a month-to-month basis. (CX-6, p. 2). Respondent admitted that he did not attempt to contact any of ComTec's clients when conducting his due diligence of the Company. (Tr. p. 1015).

[19] The PF Couple made only two principal payment contributions to the CBB Loan, and, subsequently, their required contribution was divided among the remaining investors. (Tr. p. 158).

[20] The remaining investors sold the PF Couple's property after two years for $675,000 ($650,000 after real estate fees) and used the proceeds to pay down the loan, which the remaining investors had obtained to replace the CBB Loan. (Tr. p. 857).

company; (ii) obtained a loan from another bank; and (iii) used the proceeds of the second loan to buy the CBB Loan from Colorado Bank. (Tr. pp. 165, 167). In the fall of 2004, Respondent filed for bankruptcy.[21] (Tr. p. 858).

The Customers, the SG Couple, and the MN Couple filed a civil suit against the Sellers that resulted in a settlement. (Tr. p. 167). The Customers also filed an arbitration proceeding against CFG, Mr. Leonida, and Raymond James that resulted in an arbitration award against Raymond James. (Tr. pp. 190-191).

After taking into account the proceeds from the settlement and the arbitration, and the expenses that they incurred, the Customers estimated their loss at between $180,000 and $190,000, not including the value of the time that they devoted to the matter. (Tr. pp. 169-170).

B. Respondent Committed Fraud

The Complaint alleges that, in connection with the investor group's purchase of ComTec, Respondent failed to disclose material information to the Customers and the other investors, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.

[21] Respondent testified that ComTec's assets, which were also pledged to the CBB Loan, were sufficient to cover his portion of the first $500,000 of the loan. (Tr. pp. 398-399). At the time that ComTec defaulted on the CBB Loan, the balance of the loan was below $2 million, so that Respondent was no longer obligated under the Hold Harmless Agreement.

1. Section 10(b) of the Exchange Act, SEC Rule 10b-5 Thereunder, and NASD Conduct Rule 2120: Material Omissions and Misrepresentations

Section 10(b) of the Exchange Act,[22] SEC Rule 10b-5 thereunder, and NASD Conduct Rule 2120[23] are anti-fraud provisions that prohibit fraudulent material misrepresentations and omissions in connection with the offering, purchasing, or selling of securities.[24]

In general, to find a violation of these anti-fraud provisions there must be a showing that: (1) misrepresentations and/or omissions were made in connection with the purchase or sale of securities;[25] (2) the misrepresentations and/or omissions were material; and (3) the misrepresentations and/or omissions were made with the requisite intent, *i.e.*, scienter. On the other hand, evidence of scienter is not required to establish that a misrepresentation and/or omission violated NASD Conduct Rule 2110.[26]

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[22] Section 10(b) of the Exchange Act provides:
"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

[23] Conduct Rule 2120 parallels SEC Rule 10b–5 and provides that no member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive, or fraudulent device. *Prime Investors, Inc.*, Exch. Act Rel. No. 38,487, 1997 SEC LEXIS 761, at *24 (Apr. 8, 1997) (making material misstatements of fact in connection with a sale of a security is a violation of Conduct Rule 2120).

[24] Unlike a private litigant, FINRA need not show reliance upon the alleged misrepresentation, omission, or fraudulent device, or damages resulting from such reliance. *See DBCC v. Coastline Financial, Inc.*, No. C02950059, 1997 NASD Discip. LEXIS 9 (NBCC Mar. 5, 1997).

[25] For the federal securities laws, the transactions must also involve interstate commerce or the mails, or a national securities exchange. Respondent used a means and instrumentality of interstate commerce when he communicated with his customers via telephone. *See SEC v. Hasho*, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992), 1992 U.S. Dist. LEXIS 1322, at *148-149 (1992).

[26] *Michael Alan Leeds*, Exch. Act Rel. No. 32,437, 1993 SEC LEXIS 1423 (June 9, 1993).

The "in connection with" requirement of Section 10(b) of the Exchange Act has been construed broadly to include any statement that is reasonably calculated to influence the average investor to purchase or sell a security.[27]

Facts are material if there is a substantial likelihood that a reasonable investor would consider them important in making an investment decision and would view disclosure of them as significantly altering the total mix of information made available.[28] Material facts include those that may affect the desire of investors to buy, sell, or hold a company's securities. Liability for an omission arises only if, under the circumstances, failure to disclose a fact is misleading. A duty to disclose occurs when, in light of the statements made and the surrounding circumstances, disclosure of particular facts is necessary to avoid misleading impressions.[29] A registered representative, as a securities professional, has an obligation to disclose known material facts or material facts that were "reasonably ascertainable."[30]

The Supreme Court has defined scienter as a "mental state embracing intent to deceive, manipulate or defraud."[31] Reckless or willful disregard of the truth satisfies the scienter requirement.[32] Recklessness has been defined as highly unreasonable conduct involving not merely simple or excusable negligence, but an extreme departure from the standards of ordinary care that presents a danger of misleading buyers or sellers, which is

[27] *Hasho* at 1110 ("any statement that is reasonably calculated to influence the average investor satisfies the 'in connection with' requirement of Rule 10b-5").

[28] *Basic, Inc. v. Levinson*, 485 U.S. 224, at 231-232 (1988); *TSC Indus., Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1976).

[29] *Brody v. Transitional Hospitals Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002).

[30] *Hanley v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969).

[31] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[32] *IIT v. Cornfeld*, 916 F.2d 909, 923 (2d Cir. 1980).

either known to the defendant or is so obvious that the defendant must have been aware of it.[33]

2. Material Omissions

Specifically, Enforcement alleges that Respondent fraudulently failed to disclose to all the investors that: (i) Respondent misled Colorado Bank, the investor group's lender, by failing to disclose that he had borrowed from the Sellers the $500,000 that he used to satisfy a condition of the CBB Loan; and (ii) nine months before the investor group purchased ComTec for $5 million, the Sellers paid $100,000 to extinguish a third party's 25% interest in ComTec's sale proceeds.

The Complaint also alleges that Respondent fraudulently failed to disclose to the Customers: (i) the nature and amount of the collateral pledged to guarantee the $2.5 million CBB Loan by each of the other investors in the investor group; and (ii) the financial strength, net worth, and income of the other investors in the investor group.

a. Respondent Admitted Omission of Three of the Alleged Facts

Respondent admitted that he did not disclose: (i) the $100,000 transaction; (ii) the nature and amount of the collateral pledged to guarantee the $2.5 million CBB Loan by each of the other investors in the investor group; and (iii) the financial strength, net worth, and income of the other investors in the investor group. (Tr. pp. 118, 388, 396-397, 456-457, 594, 920). However, Respondent denied that the above information was material information that he was required to disclose.

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

b. Respondent Denied that He Misled Colorado Bank

At the Hearing, Respondent denied that: (i) a condition of the CBB Loan was a requirement that the investors pay $500,000 toward the purchase price; (ii) he circumvented a condition of the CBB Loan by accepting a $500,000 loan from the Sellers; and (iii) he failed to disclose the $500,000 loan and repayment to Colorado Bank. (Tr. pp. 409, 417). For reasons described below, the Hearing Panel rejected his denials.

Prior to the Hearing, Respondent admitted that Colorado Bank required a $500,000 cash contribution to the ComTec transaction.[34] (CX-2, p. 2). Respondent initially stated that he did not tell Colorado Bank or anyone in the investor group that he had borrowed $500,000 from the Sellers, arguing that it was "private transaction" that had no financial impact on them. (CX-20, p. 11 at subpage 114; Tr. pp. 425-426).

In contrast, at the Hearing, Respondent testified that the Bank did *not* require that the investors put $500,000 toward the purchase price as a condition of the loan. (Tr. pp. 409-410, 417). Rather, he argued that the Bank's requirement that he provide written documentation that he had $500,000 in his bank account prior to the closing was really to show that he had $500,000 to put into the Company if the Sellers "stripped" that amount from the Company immediately prior to the closing, thus guaranteeing that there would be at least that much in working capital in ComTec. (Tr. pp. 435, 770-771, 778-779, 839-840). Respondent attempted to explain the inconsistencies by stating that his 2008 recollection of the events at the Hearing was more accurate than his prior statements or

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[34] In a 2005 statement describing the transaction, which he prepared for Raymond James, Respondent wrote, "[i]n December 2001 in a discussion with Doug Derks of Colorado Business Bank, [Mr. Derks] noted the fact that the Bank would be more comfortable if there was additional money being put into the deal on the front end instead of being paid out over time." (Tr. p. 418; CX-2, p. 2). In a March 27, 2006 interview with FINRA staff, Respondent stated that he prepared his 2005 written statement using his best

testimony because his prior statements and testimony were based, in part, on a review of the Bank's loan committee presentation documents, which he now realizes were inaccurate in many instances.[35] (Tr. pp. 422, 902). Based on his demeanor, his inconsistent prior admissions, the contradictory testimony of two Bank officials, and the language of the Purchase Agreement, the Hearing Panel did not find Respondent's testimony credible.

Respondent's testimony was not only inconsistent with his prior admissions, but it was directly contradicted by the testimony of two Bank officials in prior proceedings, Mr. Derks and Mr. Fullerton, who stated that it was their understanding that Respondent would be investing $500,000 in the transaction. (Tr. pp. 421-422, 900; CX-21, p. 5 at subpage 60). In a prior related civil case, Mr. Derks testified that he understood that Respondent was going to contribute $500,000 to the purchase price for ComTec and that the money was coming from an inheritance. (CX-40, p. 5 at subpage 52). At the Hearing, Respondent admitted that he told Mr. Derks that a possible source of the $500,000 could be an early inheritance. (Tr. p. 773).

Respondent argued that Section 1.2.2 of the Purchase Agreement, which states "[i]n addition to all other amounts payable under this Agreement, at the Closing [Respondent] shall pay to [the Sellers], the sum of Five Hundred Thousand Dollars ($500,000) in cash by cashier's check," was not a reference to paying $500,000 in cash as part of the purchase price of ComTec. The Hearing Panel disagrees, finding that, absent

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recollection at the time, and that some of the dates in the statement were "off a bit," but in general the information in the statement was accurate. (Tr. p. 873; CX-1, p. 5 at subpage 16).

[35] Each of the Bank's three loan committee presentation documents included the following statement, "[t]he $500M cash down will come from [Respondent] who is receiving the cash from an early inheritance." (RX-5, pp. 4, 14, 24).

a clear disclosure to the contrary, which Respondent did not make, a reasonable person would have understood, and the Bank officials did understand, this language to indicate that the $500,000 represented a contribution by Respondent to the purchase price of ComTec, rather than the repayment of a loan.

c. Omitted Facts

Respondent did not argue that he had disclosed to the investors that he had circumvented the Bank's requirement. Respondent admitted that he never told the Bank that he had gotten a loan from the Sellers. (Tr. p. 782). Although Respondent continued to claim throughout the Hearing that the other investors knew about the Sellers' $500,000 loan to him, he did admit that he never directly told them about the loan. (Tr. p. 425). Accordingly, the Hearing Panel finds that Respondent failed to disclose to all the investors that: (i) Respondent misled Colorado Bank, the investor group's lender, by failing to disclose that he had borrowed from the Sellers the $500,000 that he used to satisfy a condition of the CBB Loan; and (ii) nine months before the investor group purchased ComTec, the Sellers paid only $100,000 to extinguish a third party's 25% interest in ComTec's sale proceeds.

The Hearing Panel also finds that Respondent failed to disclose to the Customers: (i) the nature and value of the collateral pledged by the PF Couple to guarantee the $2.5 million CBB Loan; and (ii) the PF Couple's financial strength, net worth, and income, knowing that such information would have contradicted his representation that all the investors were readily able to meet their obligations under the Hold Harmless Agreement. The Hearing Panel also finds that Respondent's omissions were made in connection with the purchase of the stock of ComTec.

d. Omissions were Material

The Hearing Panel finds that each of the omissions was material because a reasonable investor would have weighed each of the omitted facts in determining whether to participate in the ComTec transaction. Each of the facts would impact a reasonable investor's calculation of the risk and the value of the transaction. For example, any reasonable investor would want to know that less than one year before the investment (less than three months before the originally proposed October 2001 closing), a presumably knowledgeable former insider accepted just $100,000 for a 25% interest in the sale proceeds of the Company, because that suggested the Company might be worth far less than what the investor group was paying. Similarly, the fact that Respondent had obtained a $500,000 loan from the Sellers and had used the funds to mislead the Bank would have been important to any reasonable investor. In that regard, the Hearing Panel notes that the Customers and investor SG testified that they would have wanted to know about the $500,000 loan and the $100,000 transaction before purchasing ComTec. (Tr. pp. 117-122, 130, 1178).

The Hearing Panel also finds that, in light of the allocation of liability among the investor group in the Hold Harmless Agreement, it would have been material to any reasonable investor in the position of the Customers to know that: (i) they were contributing a highly disproportionate share (and the only liquid share) of the collateral to secure the Bank loan; and (ii) the couple who had assumed the greatest obligation under the Hold Harmless Agreement, and who were receiving a higher proportion of the Company's stock, lacked sufficient assets to satisfy their obligation, placing the Customers at significantly greater risk than suggested by the terms of the Hold Harmless

Agreement. (Tr. p. 798). The Customers stated that they would have wanted to know that the PF Couple did not have sufficient collateral according to the Bank's valuation to cover their $1 million obligation before they purchased ComTec. (Tr. pp. 96-97, 622).

3. Scienter

Finally, the Hearing Panel also finds that Respondent made a deliberate decision when discussing the ComTec transaction with the Customers and the other investors to omit information concerning: (i) the $500,000 loan from the Sellers; and (ii) the prior $100,000 transaction.

The Hearing Panel also finds that, when reassuring the Customers about the other investors' ability to meet their obligations, especially when the PF Couple increased their obligation to $1 million, Respondent intentionally did not tell the Customers: (i) the nature and amount of the collateral pledged by the PF Couple to guarantee the $2.5 million CBB Loan; or (ii) the PF Couple's financial strength, net worth, and income.

The Hearing Panel finds that Respondent intentionally decided not to disclose the information in fear that the Customers would reconsider their investment. The Hearing Panel finds that Respondent knew that the Customers would have wanted to know that the PF Couple did not have sufficient net worth or collateral, according to the Bank's valuation, to cover their $1 million potential obligation.

Believing that the risk of a default was minimal, Respondent did not disclose to the Customers that they had pledged more collateral than their fellow investors or that they had greater exposure; he failed to disclose this information because he wanted to make certain that the Customers assessed the risk of the investment as minimal. But that was an assessment the Customers were entitled to make for themselves. The Hearing Panel finds that Respondent must have known that the information was material, because it put the Customers at far greater risk in the event of a default than the allocation of risk as reflected in the Hold Harmless Agreement.

Accordingly, the Hearing Panel finds that Respondent violated Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.

C. Respondent Made an Unsuitable Recommendation

The Complaint alleges that, when Respondent recommended that the Customers guarantee $400,000 of the $2.5 million CBB Loan to acquire 5% (later increased to 9%)[36] of the stock of ComTec, Respondent lacked a reasonable basis for believing the investment was suitable for them, as required by NASD Conduct Rules 2310 and 2110.

1. NASD Conduct Rule 2310: Suitability

NASD Conduct Rule 2310(a) provides that, in recommending to a customer the purchase of a security, a representative must have "reasonable grounds for believing that the recommendation is suitable for such customer based on the customer's other security holdings and financial situation and needs."[37] "The test for whether [the broker's] recommended investments were suitable is not whether [the customer] acquiesced in

[36] Respondent initially recommended that the Customers accept 5% of the ComTec stock in exchange for agreeing to become obligated for $400,000 of the $2.5 million CBB Loan. (Tr. p. 69). When the SG Couple agreed to join the investor group if their $400,000 obligation on the CBB Loan was valued at 9%, Respondent increased the Customers' interest from 5% to 9% of ComTec. (Tr. p. 71).

[37] *Dist. Bus. Conduct Comm. v. McNabb*, No. C01970021, 1999 WL 515761, at *13 (NAC Mar. 31, 1999).

them, but whether [the broker's] recommendations … were consistent with [the customer's] financial situation and needs."[38] "As part of a broker's suitability obligation when recommending speculative investments, a broker must ensure that a customer understands the risks involved, in addition to determining that the recommendation is suitable for the customer."[39]

2. The Customers

Respondent initially argued that his invitation to the Customers to join the investor group was not a recommendation by him in his capacity as the Customers' broker, but rather as a friend.

There is no dispute that during the period from 1999 to 2001, Respondent's business relationship with the Customers became a close social relationship. (Tr. pp. 46, 49-50, 701, 718-719).

However, the Customers had been clients of Respondent since September 1997. (Tr. pp. 36, 335-336, 1226). Respondent was primarily responsible for portfolio review and investment recommendations. (Tr. pp. 45, 336-337, 1230). The Customers were clients of both CFG and Raymond James.[40] (Tr. p. 335). The Customers relied on Respondent's recommendation to invest in ComTec because of their business relationship with Respondent. Respondent induced the Customers to pledge one of their Raymond James accounts to secure the CBB Loan. The Hearing Panel finds that the ComTec

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[38] *Wendell D. Belden*, Exch. Act Rel. No. 47,859, 2003 SEC LEXIS 1154, at *11 (May 14, 2003).

[39] *Dept. of Enforcement v. Frankfort,* No. C02040032, 2007 NASD Discip. LEXIS 16, at *31 (NAC May 24, 2007).

[40] During the relevant period, CFG paid Respondent a salary, and Respondent's commissions on the Customers' transactions flowed through Raymond James. (CX-1, p. 3 at subpage 12).

transaction was recommended by Respondent, at least in part, in his role as the Customers' registered representative, and therefore Conduct Rule 2310 applies.

At the time of the ComTec transaction in April 2002, ML was 43 years old, employed full-time as an anesthesiologist, and earned $300,000 to $350,000 annually. (Tr. p. 102; RX-3, p. 1). CL was 42 years old and was not employed outside the home. (Tr. p. 104; RX-3, p. 10). The Customers have two children. (Tr. p. 36). ML set a target of retiring at the age of 55. (Tr. p. 405).

The Customers' primary investment objective was growth, with a medium to high-risk tolerance, from the time that they joined CFG through the acquisition of ComTec.[41] (Tr. pp. 42, 44). According to the Customers' financial statement dated August 2001, their net worth was approximately $2.1 million. (Tr. p. 106; CX-30). Of this amount, approximately $1.3 million was invested in stocks or bonds with Raymond James.[42] (CX-30).

In 2002, Respondent relayed to the Customers that based on the Bank's formula their property was worth only $320,000 and therefore insufficient as collateral.[43] (Tr. pp. 74-76, 183, 223-224, 569). Accordingly, in February 2002, the Customers agreed to pledge one of their securities accounts at Raymond James to make up their shortfall. (Tr. pp. 259, 569, 635). When the Customers agreed to pledge their account, the actual net value of their account was $595,000. (CX-25). By the closing, using the Bank's

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[41] In 1998, CFG transferred its affiliation from FINRA member Fahnstock & Co. to Raymond James. (Tr. p. 1224). Accordingly, the Customers completed new account forms that reflected their investment objectives for Raymond James on July 28, 1998. (Tr. p. 703; RX-3, pp. 1-6).

[42] The $1.3 million in securities included non-liquid retirement assets held at Raymond James that were not included in the pledged account. (Tr. p. 338).

[43] Without taking into account the Bank's discount and the mortgage owed, the Customers' property was valued at $900,000. (RX-5, p. 26).

discounted formula and adding assets from other Raymond James securities accounts, the Customers provided collateral valued at $984,000 ($320,000 on their house and $664,000 in their Raymond James account) to meet their $400,000 obligation under the Hold Harmless Agreement. (RX-5, p. 25).

3. ComTec Purchase Was Not Suitable

The Hearing Panel finds that ComTec was not a suitable recommendation for the Customers because, as structured, the investment was far riskier for the Customers than for the other investors, and, as explained above, Respondent failed to disclose material facts that were essential for the Customers to understand and evaluate that risk. As a result, the Customers pledged collateral exceeding 60% of their actual assets, and nearly all of their liquid assets, without understanding the full extent of their exposure.

At the Hearing, Respondent testified that he explained the PF Couple's situation to CL, and that she orally agreed on behalf of her spouse and herself to pledge their securities account to meet the collateral shortfall of the PF Couple. (Tr. pp. 392-393, 791). In contrast, the Customers testified that they pledged their securities account because there was a shortfall in *their* own collateral. (Tr. pp. 259-260).

Having observed the witnesses' demeanor, the Hearing Panel finds that Customers were more credible than Respondent. Moreover, it is not credible that the Customers would have pledged additional collateral to satisfy the shortfall of the PF Couple without suggesting an adjustment in their respective ownership interests. Without such an adjustment, the Customers undertook significantly greater risk than the PF Couple for a much smaller ownership share.

Furthermore, because the investors' obligations on the CBB Loan were joint and several, the Customers were in fact assuming a $2.5 million potential liability. Even if Respondent had disclosed the omitted information described above, it was not suitable for Respondent to recommend that the Customers, with a net worth including retirement assets of approximately $2.1 million, risk up to $2.5 million in a single investment. Similarly, even if Respondent had made the disclosures, it was not suitable for Respondent to recommend that the Customers pledge their Raymond James account, thereby tying up all of their liquid assets until the loan was paid.

Respondent also argued that ComTec was suitable for the Customers because they had risked that amount on a similar "joint and several" investment in a surgical center.[44] However, Rule 2310 requires that a registered representative have reason to believe that each specific securities transaction is appropriate for a particular investor. For the reasons set forth above, the ComTec investment was not suitable for the Customers, and moreover, "even if [the Customers] possessed the requisite acumen, [they were] not provided sufficient information to make an informed decision" regarding the ComTec investment.[45]

Accordingly, the Hearing Panel finds that Respondent lacked reasonable grounds for believing that his recommendation that the Customers invest in ComTec was suitable for them. Therefore, the recommendation violated NASD Conduct Rule 2310. A violation of NASD Conduct Rule 2310 is also a violation of NASD Conduct Rule 2110.

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[44] In 2000, ML with 23 other physicians guaranteed a loan to construct a free standing surgical center in Colorado. (Tr. pp. 109, 233). ML knew each of the other physicians personally and was confident that they had the financial assets to pay their pro rata share of the loan. (Tr. pp. 234-235). ML's pro rata potential obligation on the loan was $424,000. (Tr. p. 328).

[45] *David Joseph Dambro*, 51 S.E.C. 513, 516 (1993).

III. SANCTIONS

A. Intentional Misrepresentations or Material Omissions of Fact

For intentional or reckless misrepresentations or material omissions of fact, the *FINRA Sanction Guidelines* recommend fines ranging from $10,000 to $100,000, suspensions of 10 business days to two years, and, in egregious cases, a bar.[46] In addition, a fine may be increased by the amount of the respondent's financial benefit.[47] Arguing that Respondent's conduct was egregious, Enforcement recommended a bar.

The Hearing Panel considered the following general principal considerations: (i) whether the misconduct was intentional; (ii) whether respondent accepted responsibility for his misconduct; (iii) whether respondent attempted to conceal his misconduct; (iv) whether the misconduct resulted in injury to the public; and (v) whether respondent's misconduct had the potential for respondent's monetary or other gain.

First, Respondent deliberately failed to disclose to all the investors that he had misled Colorado Bank about the financing of the transaction, *i.e.*, the $500,000 loan from the Sellers, and that the Sellers had paid only $100,000 for a 25% interest in the proceeds of a sale of ComTec, and failed to disclose to the Customers the PF Couple's financial condition or value of their collateral. Respondent intentionally did not disclose the information because he did not want anything to prevent the completion of the transaction.

Second, Respondent continues to deny responsibility for, or acknowledge his misconduct; in fact, Respondent blames the Customers for relying on him rather than

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[46] *FINRA Sanction Guidelines*, p. 93 (2007), available at *http://www.finra.org/web/groups/enforcement/documents/enforcement/p011038.pdf*.

[47] *Id.* at 5.

carefully reading the documents themselves. He continues to argue that the information was not material when he must have known that any reasonable investor would have wanted to know that: (i) he was borrowing from the Sellers to complete the transaction; (ii) less than a year prior to the sale (less than three months, if the sale had not been postponed from October 2001), the Sellers purchased the 25% interest in the ComTec sale proceeds for just $100,000; and (iii) the information regarding the respective amounts of collateral contributed by the investors that contradicted representations about the investors' ability to satisfy their obligations under the Hold Harmless Agreement in the event of a default.

Third, at the Hearing, Respondent falsely denied that a condition of the CBB Loan was a $500,000 payment from the investor group, and continued to falsely state that the investor group knew about the $500,000 loan to him from the Sellers, even after admitting that he did not directly tell them about the loan.

Fourth, the Customers suffered a significant financial loss because of Respondent's misconduct. Although the Customers reached a settlement with the Sellers and Raymond James, they did not recoup their entire loss, and Respondent's actions required the Customers to file a civil proceeding and an arbitration proceeding in order to recoup some of their loss.

Finally, it is clear that Respondent engaged in the misconduct because of his self-interest, *i.e.*, the possibility of acquiring a 57% interest in ComTec for virtually nothing but his time.

There is no dispute that Respondent had convinced himself of the future success of ComTec. The Customers testified that Respondent did not expect ComTec to fail and default on the CBB Loan. (Tr. pp. 53-54). Although the Hearing Panel agrees with the Customers that Respondent was not deliberately attempting to harm them, the Hearing Panel finds that Respondent's conduct was egregious, and warrants a bar.

B. Respondent Made an Unsuitable Recommendation

For unsuitable recommendations, the *FINRA Sanction Guidelines* suggest a fine of $2,500 to $75,000, a suspension of 10 business days to two years, and, in egregious cases, a bar.[48]

Enforcement argued that Respondent's misconduct was egregious and warranted a bar. The Hearing Panel considered the same general principal considerations discussed above. Respondent's misconduct was intentional; he knew that the Customers believed any potential loss was limited to $400,000 based on his representation that everyone else had pledged enough collateral to satisfy their obligations under the Hold Harmless Agreement. Respondent made that representation knowing that the Customers, relative to the other investors, had pledged more assets and were at greater risk without receiving a greater potential for reward.

Respondent continues to deny his responsibility. He continues to argue inconsistent positions that the Customers should have known that they had "joint and several" liability of $2.5 million, but that in determining suitability, the Customers' risk was really limited to $400,000. With proper disclosure, the Customers may have determined to invest anyway; but Respondent denied them that material information and made the decision for them.

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[48] *Id.* at 99.

The Hearing Panel also finds it particularly egregious that Respondent testified falsely that the Customers agreed to pledge their securities account to cover the PF Couple's collateral shortfall, when he had represented to the Customers that all of the investors in the group had sufficient assets to meet their obligations.

The Hearing Panel also finds Respondent's actions egregious because Respondent solicited the Customers knowing that they would simply rely on Respondent's description of the investment and the investment terms, and not question Respondent's possible self-interest.

Finding that Respondent's recommendation of the ComTec investment to the Customers was egregious, the Hearing Panel finds that Respondent's conduct warrants a bar.

IV. CONCLUSION

The Hearing Panel bars Respondent Gerald J. Kesner from association with any FINRA member in any capacity for violating: (1) NASD Conduct Rules 2310 and 2110, as set forth in count one of the Complaint; and (2) Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110, as set forth in count two of the Complaint. The Hearing Panel also orders that Respondent pay the $4,075.70 costs of the Hearing, which include an administrative fee of $750 and hearing transcript costs of $3,325.70.

The costs shall be due and payable when, and if, Respondent seeks to return to the securities industry. If this Hearing Panel Decision becomes the final disciplinary action of FINRA, the bars shall become effective immediately.[49]

HEARING PANEL.

By:______________________
Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
August 15, 2008

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[49] 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.