FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. MERRIMAC CORPORATE SECURITIES, INC. (CRD No. 35463), Respondent.	Disciplinary Proceeding No. 2007007151101 Hearing Officer – LBB **HEARING PANEL DECISION** December 8, 2010

For violating NASD Rules 1017 and 2110 by engaging in types of business not authorized by its NASD membership agreement, Respondent is fined $5,000. For failing to establish and maintain adequate written supervisory procedures for sales of certain types of securities, in violation of NASD Rules 3010 and 2110, Respondent is fined $2,500. For willfully failing to maintain adequate books and records with respect to communications by e-mail, in violation of Section 17(a) of the Securities Exchange Act of 1934, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110, Respondent is fined $10,000. For willfully failing to make and keep current purchase and sale blotters for its direct application mutual fund and variable annuity businesses, in violation of Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110, and NASD Rule 2110, Respondent is fined $1,000.

Appearances

For the Department of Enforcement, Michael A. Gross, Senior Regional Counsel, and David B. Klafter, Deputy Chief Regional Counsel, Boca Raton, Florida.

For Respondent, Alan M. Wolper, Esq., and Martin W. Jaszczuk, Esq. Chicago Illinois.

DECISION

I. Procedural Background

The Department of Enforcement filed the Complaint in this disciplinary proceeding on September 24, 2009, asserting five causes of action against Respondent Merrimac Corporate

Securities, Inc. ("Merrimac"). The first cause of action charges Merrimac with selling four categories of securities that it was not permitted to sell by its membership agreement, thereby violating NASD Membership Rule 1017 and Conduct Rule 2110.[1] The second cause of action charges Merrimac with having inadequate written supervisory procedures with respect to the sale of the four categories of securities, in violation of NASD Conduct Rules 3010 and 2110. The third cause of action charges Merrimac with having inadequate written supervisory procedures with respect to variable annuity sales, in violation of NASD Conduct Rules 3010 and 2110. The fourth cause of action charges Merrimac with violating Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Exchange Act Rule 17a-4 by failing to maintain adequate books and records with respect to the preservation of e-mails, thereby also violating NASD Conduct Rules 3110 and 2110.[2] The fifth cause of action charges Merrimac with violating Section 17(a) of the Exchange Act and Exchange Act Rules 17a-3 and 17a-4 by failing to make and keep current purchase and sale blotters for its direct application mutual fund and variable annuity businesses, thereby also violating NASD Conduct Rules 3110 and 2110.

A hearing was held in Boca Raton, Florida, on August 3 – 5, 2010, before a Hearing Panel composed of a current member of the District 7 Committee, a former member of the District 7 Committee, and a Hearing Officer.

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[1] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the NASD Conduct and Membership Rules that were in effect at the time of Respondent's alleged violations. The applicable rules are available at www.finra.org/rules.

[2] A violation of an SEC or NASD rule is conduct inconsistent with just and equitable principles of trade, and violates NASD Rule 2110. *See, e.g.*, *Alvin W. Gebhart*, Exchange Act Rel. No. 53136, 2006 SEC LEXIS 93, at *54 (Jan. 18, 2006), *rev'd and remanded in part on other grounds*, 2007 U.S. App. LEXIS 27183 (9th Cir. 2007).

II. Respondent

Merrimac has been a FINRA member since December 1993. Stip. 1.[3] In about 1993, Stephen Pizzuti formed Allen Douglas Securities, a FINRA member firm. Tr. 397, 484. In 2003, Team Advisory Corporate, Inc., owned by Kristen Pizzuti, Stephen Pizzuti's wife, acquired Merrimac.[4] Stip. 2; Tr. 50, 490. In late 2003, the management team from Allen Douglas became the management team at Merrimac. Tr. 51.

Merrimac currently employs about 62 registered persons and one non-registered person. The firm's headquarters are in Altamonte Springs, Florida, and it has branches in three other Florida cities. Stip. 3. Since its acquisition by Team Advisory, Merrimac has operated a general retail securities business. Stip. 4.

Stephen Pizzuti has been in the securities business since 1986. Tr. 483. He served as a branch manager for Merrimac from 2003 to 2008, and has been Merrimac's CEO since 2008. Between approximately 2003 and 2007, David Matthews served as Merrimac's president and chief compliance officer. Mark Thomes, Kristen Pizzuti's brother, has been in charge of preserving the firm's business-related electronic communications since 2003. Thomes also has been the firm's chief financial officer and Financial and Operations Principal during that period. Stip. 5; Tr. 282 – 283, 298, 496, 574. All testified at the hearing.

III. Summary of Findings and Conclusions

Respondent violated FINRA's Rules with respect to each of the Complaint's five causes of action. With respect to the first cause of action, Respondent violated its membership agreement by selling private placements, non-traded REITs, limited partnerships, and direct

[3] References to the exhibits provided by Enforcement are designated as "CX-___." References to the exhibits provided by Respondent are designated as "RX-___." The parties filed a brief set of factual stipulations on July 2, 2010. References to the stipulations are identified as "Stip. ___." References to the hearing transcript are designated as "Tr. ___."

[4] Kristen Pizzuti does not have any securities licenses. Tr. 50 – 51.

participation programs (the "Four Products"),[5] thereby violating Rules 1017 and 2110. Respondent's sales of the Four Products represented a substantial part of Respondent's business, but the Four Products were not included in the list of the types of businesses authorized by Respondent's membership agreement. Rule 1017 requires a member firm to file an application with FINRA for approval of a material change in the firm's business operations. The materiality of a change is determined by the facts and circumstances of each case. The considerations most relevant to this case were the nature of the proposed expansion, and the relationship, if any, between the proposed new business activity or expansion and the firm's existing business. Under the facts and circumstances of this case, the Hearing Panel finds that the sale of each of the Four Products was a material change from the types of businesses authorized by Respondent's membership agreement, and that Respondent violated Rules 1017 and 2110 by selling the Four Products despite failing to file an application with FINRA for approval.

Respondent's written supervisory procedures for sales of the Four Products and variable annuities were inadequate, as charged in the second and third causes of action. Despite substantial sales of the five types of securities, Respondent's written supervisory procedures did not include any specific procedures for them. The absence of such procedures violated Rules 3010 and 2110.

Respondent violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by willfully failing to preserve all incoming business-related e-mails or any internal e-mails from early 2005 until October 2006. Respondent also violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 from early 2005 until November 2007 by failing to maintain its electronic e-

[5] Enforcement referred to this collection of types of securities as "the Unapproved Products" during the hearing. Respondent preferred to refer to them collectively as "the Products."

mail records in non-erasable, non-rewritable format; failing to maintain its e-mails in an easily accessible place; and failing to notify FINRA prior to its use of electronic storage media.

Respondent willfully failed to make and keep current purchase and sale blotters for its direct application mutual fund and variable annuity businesses, in violation of Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110, and NASD Rule 2110. The Hearing Panel rejects Respondent's contention that commission runs produced by issuers are adequate to satisfy the requirement to maintain purchase and sale blotters.

In total, the Hearing Panel imposes a fine of $18,500. In addition to considerations directly related to the violations in determining the appropriate sanctions, the Hearing Panel considered Respondent's precarious financial condition, as demonstrated by testimony and documentary evidence, in determining the appropriate sanctions.

IV. Respondent Violated Rules 1017 and 2110 by Violating Its Membership Agreement

A. Facts

The First Cause of Action charges Merrimac with selling the Four Products – private placements, non-traded REITs, limited partnerships, and direct participation programs[6] – in violation of Respondent's FINRA membership agreement. There is no dispute that Respondent's sales of the Four Products were substantial, or that the Four Products were not expressly listed among the approved types of business in Respondent's membership agreement. The Hearing Panel finds that the sale of each of these securities was a material change in Respondent's business for which Membership Rule 1017 required the filing of an application for approval of a change in business operations, and FINRA approval, prior to their sale.

[6] A direct participation program is "a program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, real estate programs, agricultural programs, cattle programs, condominium securities, Subchapter S corporate offerings, and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof." NASD Rule 2810(a)(4).

1. Merrimac's Continuing Membership Application in 2003

In 2003, Stephen Pizzuti, who was the owner of Allen Douglas Securities, another small brokerage firm, wanted to acquire a firm primarily to conduct online business. Tr. 48, 487 – 489. After Pizzuti identified Merrimac as meeting his requirements, Merrimac filed a Continuing Membership Application ("CMA") with FINRA, seeking approval for a change in ownership and management to permit Team Advisory, Pizzutti's wife's company, to purchase the firm, and the Allen Douglas management team to operate it. Tr. 285.

On June 5, 2003, a FINRA examiner sent a letter to Merrimac with questions concerning the Merrimac CMA, including several about Merrimac's planned private placement activities and underwriting activities. CX-13. In response, David Matthews sent a letter to the examiner on July 3, 2003, representing that the firm would not initially be engaging in such activities. Matthews wrote, "With respect to the proposed underwriting activities, and private placement activities, we respectfully request deferring these activities until a later time period. Accordingly our business plan has been amended to exclude these functions."[7] However, the previous paragraph in the letter suggested that Matthews had not intended to exclude the sale of private placements from the business plan. In discussing the firm's proposed online business, Matthews wrote, "The firm plans to offer on-line, all of the products and services described in our business plan. These include … private placements, and best efforts underwritings." CX-14. Matthews testified that what he intended to say in the letter, and still believes he said, was that Merrimac

[7] Although the Complaint alleged a violation with respect to four types of securities, the dominant concern through the period covered by the Complaint was with the sale of private placements, and much of the evidence adduced at the hearing related specifically to private placements rather than all four types of securities.

did not intend to underwrite private placements, but that the firm always intended to sell private placements. Tr. 335 – 336, 373.[8]

The Allen Douglas management team, which was the prospective management of Merrimac, met with FINRA examiners in Atlanta on July 11, 2003. They told the examiners that they wanted Merrimac to conduct the same types of business that Allen Douglas conducted, but focus on online business. Tr. 285, 400, 493 – 494. They discussed what Merrimac was authorized to do and whether Allen Douglas people were qualified to do it. Tr. 333 – 334. Allen Douglas was a full-service retail brokerage firm, selling stocks, bonds, options, and the Four Products. Allen Douglas's membership agreement permitted it to sell the Four Products. Tr. 341, 485 – 486. Like Allen Douglas, Merrimac had been allowed to sell the Four Products prior to its acquisition by Team Advisory. Tr. 333 – 334, 348, 400, 488 – 489.

2. The Membership Agreement

Matthews, as Merrimac's president, and Thomes, as its FINOP, signed the firm's membership agreement on September 8, 2003. CX-15. Matthews testified that he "scanned" it before he signed, while Thomes testified that he read the agreement. Tr. 59, 288. The agreement listed the following types of business that the firm was authorized to conduct:

- Broker retailing corporate debt securities;
- Broker retailing corporate equity securities over-the-counter on an agency or riskless principal basis;
- U.S. government securities broker;
- Investment advisory services;
- Mutual fund retailer on an application basis or through a clearing firm;

[8] Despite the plain language of the letter excluding private placements from Merrimac's current business plans, the Hearing Panel found Matthews's testimony credible, primarily because it did not make sense for the firm to exclude the Four Products from its plans when they were a part of Merrimac's existing business, and a substantial part of Allen Douglas's business. Thus, in determining sanctions, the Hearing Panel considered Matthews' drafting of the letter, and his belief that the membership agreement permitted the sale of the Four Products, to be negligent.

- Municipal securities broker;
- Non-exchange member arranging for transactions in listed securities by exchange member;
- Put and call broker;
- Broker selling variable life insurance or annuities; and
- Provider of online brokerage services through a clearing firm.

CX-15. The Four Products were not on the list.

3. Subsequent Communications and Events Relating to the Scope of Merrimac's Business Activities

In 2004, several Allen Douglas brokers sought to register with Merrimac. Tr. 63. On March 17, 2004, Nancy P. Mills, a FINRA Supervisor of Examiners, sent two letters to Matthews relating to the proposed transition of the brokers and their business from Allen Douglas to Merrimac. The first letter concerned a CMA for Allen Douglas, and asked a number of questions about the plans for Allen Douglas in light of the proposed transfer of substantially all of Allen Douglas's assets, most of its customer accounts, and several of its brokers to Merrimac. RX-2 at 2.[9] The second letter concerned the effect of the proposed transactions on Merrimac. Mills wrote, "NASD has concluded that the changes do not constitute a material change in operations. As a result, your firm is not required to file an application pursuant to Rule 1017. This determination is based on, among other things, 1) the firm's business activities will remain the same…." Further, Mills noted, "This determination is based upon representations made to the staff by the firm regarding the proposed change." RX-2 at 1. Matthews thought the second letter acknowledged that Merrimac could sell the Four Products because the examiner's conclusion that an application pursuant to Rule 1017 was unnecessary was based on the assumption that the firm's business activities would remain the same. Tr. 338 – 339, 377.

[9] Allen Douglas ceased operating in 2004 because it became net capital deficient due to what it regarded as a change by SEC staff in accounting requirements with respect to liabilities. Tr. 397 – 398, 486 – 487.

Merrimac filed an amended Form BD on November 24, 2004. In Section 12 of the form, in which firms are required to identify the types of businesses in which the firm is engaged or in which it will engage, Thomes checked off, among other types of business, “Underwriter or selling group participant (corporate securities other than mutual funds),” “Broker or dealer selling tax shelters or limited partnerships in primary distributions,” “Broker or dealer selling tax shelters or limited partnerships in the secondary market,” and, “Private placements of securities.” CX-17 at 7 and 8.

On January 26, 2005, Ger Xiong, a FINRA examiner (Tr. 131), sent an e-mail to an employee in Merrimac’s operations department, for Matthew’s attention, concerning a conversation with Matthews about Merrimac’s Form BD. The e-mail stated, “Per our conversation, the following items are not listed as approved business activities for the firm per its Membership Agreement and should be removed from the firm’s Form BD,” and listed the following types of business activities to be deleted:

1. Underwriter/selling group participant
2. US government securities dealer
3. Broker or dealer selling tax shelters or limited partnerships primary distributions
4. Broker or dealer selling tax shelters or limited partnerships in the secondary market
5. Private placement of securities.

CX-16. The Merrimac employee who received the e-mail delivered it to Thomes, rather than Matthews, because Thomes was in charge of Merrimac’s Form BD. Tr. 73. While Matthews did not remember receiving the e-mail, Thomes testified that he discussed it with Matthews. Tr. 73, 475 – 476.

Upon being told to remove the business lines from the Form BD, Thomes understood that the Form BD was not “in sync” with Merrimac’s membership agreement. Tr. 290, 402 – 403.

Thomes had not known that the Form BD and Membership Agreement "went together" until that time, apparently thinking that the documents bore no necessary relationship to each other. Tr. 292. Thomes revised Merrimac's Form BD on March 8, 2005. He unchecked the boxes for "Underwriter or selling group participant corporate securities (other than mutual funds)," "U.S. government securities dealer," "Broker or dealer selling tax shelters or limited partnerships in the secondary market," and "Private placement of securities." CX-18 at 7 – 8; Tr. 291 – 293, 448. Thomes again revised the Form BD on April 11, 2005, removing "Broker or dealer selling tax shelters or limited partnerships in primary distributions." CX-19; Tr. 293.

In November 2005, Matthews became concerned about the types of business in which Merrimac was authorized to engage, and sent two letters to Russell Henson of FINRA's Boca Raton office seeking clarification. Tr. 75, 76, 343, 380.[10] Matthews wrote on November 8, 2005, "In routine review of our B/D CRD, it is probably a good idea for us to clarify activities in which the firm may engage relative to Membership Agreement B(3) item two." Matthews described a private placement transaction, asserted that it was not a material change under the Form BD because the category "Other" was checked on the form, and requested clarification without a Rule 1017 filing. RX-3.[11] Matthews did not receive a response to the letter. Tr. 201, 342. Matthews sent a second letter to Henson on November 14, 2005. He stated, "After the

[10] It is not clear what prompted Matthews to write to NASD. Matthews testified that he was not aware that NASD had requested the deletion of certain lines of business from the Form BD because the matter was referred to Thomes. Tr. 73. However, Matthew testified that a need for clarification arose as a result of communications between Thomes and the NASD concerning the lines of business on the Form BD, which prompted Matthews to write to the NASD in November 2005. He testified that the concern "had to come from [Thomes] because … I never had anything to do with the membership agreement. Tr. 380 – 384, 388 – 389. Matthews appeared confused about this sequence of events. The November 2005 letter was sent too late to have resulted from the communications between Thomes and Ger Xiong in January 2005, so it is unclear whether, or when, Matthews knew of the deletions from Merrimac's Form BD.

[11] Matthews's letter confused the Form BD and the membership agreement. A material change is an issue for a membership agreement. Form BD lists specific categories of lines of business, without designating them as constituting a material change. Thus, even if private placements were properly considered to be included in the "Other" category on the Form BD, it did not affect the determination of whether expansion into private placements constituted a material change for purposes of the membership agreement. See discussion below.

acquisition of Merrimac, it escaped notice that the new Membership Agreement did not specifically contain private placements. However, as the firm has previous experience conducting private placement transactions, and Merrimac had previously already been permitted to do so, we respectfully request that we be allowed to offer private placements. We ask that our request be considered an immaterial change in our business operations that is not subject to NASD Rule 1017." RX-3. Matthews again did not receive a response from Henson, and concluded that the assertions in his letter must be correct, because, "being a regulator, I felt that if they weren't correct, I would darn well hear from them." Tr. 79, 201, 386. He testified that he "considered the matter documented" and assumed that Merrimac could continue to sell private placements. Tr. 79. There is no evidence that he ever had any concerns about the sale of direct participation programs, non-traded REITS, or limited partnerships, or considered whether they were included in the list of approved lines of business in the membership agreement.

4. Respondent Sold the Four Products

Between 2004 and September 2007, Merrimac sold private placements, non-traded REITs, limited partnerships, and direct participation programs. Stip. 8, 9; CX-21; Tr. 83. Merrimac received $1,723,922.59 in commissions for sales of these types of securities. Its total sales of the Four Products were $25,020,994.12. CX-26, 27; Tr. 147.

Both Matthews and Thomes testified that they did not believe that Merrimac was violating its membership agreement by selling the products, but for different reasons. Matthews testified that he always believed that Merrimac was authorized to sell the Four Products. Although the Four Products were not listed expressly in the membership agreement, he believed that private placements were included in the categories authorizing retailing corporate debt securities and over-the-counter sales of corporate equity securities. Tr. 61 – 62, 350. The Hearing Panel did not find his explanation credible. Matthews was inconsistent on whether he believed that Merrimac had been authorized to sell the Four Products before November 2005. He testified at one point that he knew that Merrimac was not authorized to sell the products before November 2005, and that he sought to amend the agreement because he believed the failure to include the Four Products in the agreement was an error. Tr. 78. The more likely explanation is that Matthews had paid little attention to the membership agreement, merely scanning the agreement when he signed it and assuming that the firm had been approved to sell all the products that had been discussed. When he first paid attention to what the firm was authorized to sell, in November 2005, his letters reflect concern that the firm was not authorized to sell private placements.

Thomes did not think Merrimac was selling private placements, and therefore did not think Merrimac was violating the membership agreement. Tr. 294, 403 – 404. He testified he understood that the firm could not sell private placements when he unchecked the box for private placements on the Form BD. The securities that he noticed on the reports he reviewed as the firm's FINOP were registered with the SEC so he did not think they were private placements. He incorrectly believed that a private placement could only be a small offering with 35 or fewer investors. Tr. 404, 448, 452 – 453. Similarly, he understood that Merrimac was not approved to sell limited partnerships when he unchecked the box on the Form BD, but he did not think Merrimac was selling limited partnerships. Tr. 294, 453 – 454.

In about October 2007, a FINRA examiner notified Respondent that it was not approved to sell the Four Products. The firm stopped selling them and filed for approval to sell them, under NASD Rule 1017. The approval was subsequently granted, and the firm became authorized to sell them. Tr. 135 – 136, 209 – 210.

B. Respondent Violated Rules 1017 and 2110 by Selling the Four Products in Violation of Its Membership Agreement

The determination of whether a business expansion is a material change is based on the facts and circumstances of each case. In this case, the Hearing Panel finds that selling the Four Products was a material change from the lines of business that were authorized by the membership agreement.

1. Membership Rule 1017 Requires FINRA's Approval for Engaging in New Types of Businesses that Constitute a Material Change from Existing Businesses

Membership Rule 1017(a)(5) requires FINRA members to file an application with the Department of Member Regulation for approval of material changes in business operations.[12] Rule 1017(c)(3) prohibits the implementation of a material change in business operations unless the change is approved by FINRA, either by agreement with the Department of Member Regulation or as a result of a membership proceeding.

An October 2000 Notice to Members set forth the following non-exhaustive list of criteria that may be considered in determining what is considered a material change in business operations:

- the nature of the proposed expansion;
- the relationship, if any, between the proposed new business line and the firm's existing business;
- the effect the proposed expansion is likely to have on the firm's capital;
- the qualifications and experience of the firm's personnel; and
- the degree to which the firm's existing financial, operational, supervisory and compliance systems can accommodate the proposed business expansion.[13]

[12] Rule 1017 refers to Rule 1011(k) for the definition of "material change." Rule 1011(k) provides a short, non-exclusive list of changes that are considered material. The rule provides, "The term 'material change in business operations' includes, but is not limited to: (1) removing or modifying a membership agreement restriction; (2) market making, underwriting, or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under SEC Rule 15c3-1."

[13] NTM 00-73 at page 569 (available at www.finra.org/Industry/Regulation/Notices/2000/P003544).

The Notice noted that the addition of a line of business "is often a significant event that has an impact on the firm's supervisory and compliance infrastructure, personnel and/or finances."[14] The determination of whether expansions into particular lines of business will be considered material changes "are to be evaluated on a facts and circumstances, case-by-case basis."[15]

2. The Sale of the Four Products Was a Material Change

Under the facts and circumstances of this case, the sale of private placements, non-traded REITs, limited partnerships, and direct participation programs constituted a material change in Merrimac's business operations from the lines of business permitted by the firm's membership agreement.

The nature of the securities is sufficient to establish that the expansion of Respondent's business into the sale of the Four Products was a material change from what was permitted by its membership agreement. Private placements, non-traded REITs, limited partnerships, and direct participation programs all have features that make them materially different from ordinary equities that are sold over the counter, both in terms of the sale of the products and the supervision of the sales.

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[14] NTM 00-73, at 569.

[15] NTM 00-73 at 569. Under an earlier proposal, the membership agreement would have strictly limited members to the businesses explicitly listed in their membership agreements. The proposal would have required a provision in membership agreements that would have required members to agree to "engage only in the business set forth in the business plan and the membership agreement." *See Notice of Filing of a Proposed Rule Change by the National Association of Securities Dealers, Inc. ("NASD") to Proposed Changes in the By-Laws of the NASD, NASD Regulation, Inc., The Nasdaq Stock Market, Inc., the Plan of Allocation and Delegation of Functions by the NASD to Subsidiaries, Membership Application Procedures, Disciplinary Proceedings, Other Proceedings, and Other Conforming Changes,* Exchange Act Rel. No. 38545, 1997 SEC LEXIS 959, *96 (Apr. 24, 1997). The requirement of inclusion of this provision in the membership agreement was deleted from the proposed rule at the suggestion of NASD Regulation. *See Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by NASD Regulation, Inc. Relating to Amendments to Membership Rules*, Exchange Act Rel. No. 42885, 65 FR 36860, at 36875 (June 12, 2000).

Private placements are securities offered under SEC Regulation D, which established three exemptions from Securities Act registration in Rules 504 - 506.[16] There are specific requirements under each of the three rules, such as restrictions on the dollar size and number of investors, limitations on how long an offering may be available, investor qualifications, investor sophistication, and resale restrictions. Broker-dealers have an obligation to conduct an investigation consistent with the characteristics of these securities. In FINRA's recent Regulatory Notice concerning Regulation D offerings, FINRA reminded broker-dealers that, at a minimum, they should conduct a reasonable investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held or to be acquired by the issuer;
- the claims being made; and
- the intended use of the proceeds of the offering.[17]

The requirements to comply with specific SEC Rules, and to conduct a reasonable investigation consistent with the characteristics of private placements, establish that the sale of private placements is materially different from the sale of ordinary equities, and constitutes a material change in business operations.

Sale of direct participation programs was also a material change from the businesses approved in the membership agreement. Direct participation programs are illiquid investments.[18] They are subject to NASD Rule 2810, which prescribes standards and procedures

[16] 17 C.F.R. § 230.501 *et. seq*.; *see Regulation D Offerings*, FINRA Reg. Notice 10-22 (Apr. 2010).

[17] Reg. Notice 10-22 (Apr. 2010).

[18] *Raymond James & Assoc.*, Exchange Act Rel. No. 38893, 1997 SEC Lexis 1581, at *14, n.18 (Aug. 1, 1997) (describing the market for direct participation programs as diffuse and illiquid, and lacking in price transparency).

for sales practices for the programs.[19] The rule has specific suitability requirements, including a determination that the investor will be able to realize the benefits described in the prospectus, including tax benefits, and that the participant has sufficient net worth to sustain the risks inherent in the program, including loss of investment and lack of liquidity. The rule also requires certain disclosures, including disclosure that direct participation programs are illiquid.[20] Direct participation programs are also subject to a specific provision in Rule 2340 concerning the valuation of the programs for account statements. The applicability of specific rules supports a finding that expansion into a new product line is a material change, because a firm that is qualified to sell ordinary equities might not be capable of compliance with the rule governing the new product line.

Expansion into non-traded, or unlisted, REITs was also a material change. Non-traded REITs are illiquid. Beginning in 2008, Rule 2810 expressly began to govern unlisted REITs, codifying FINRA's pre-existing policy.[21] NASD Rule 2810(b)(3) requires that firms, prior to participating in a public offering of a real estate investment program, have reasonable grounds to believe that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program. The rule prohibits participation in the offering if the offering expenses

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[19] NASD Rule 2810 has been retired, and FINRA Rule 2310 now sets forth certain requirements with respect to sales practices for direct participation programs. *See* Reg. Notice 09-33 (June 2009).

[20] Rule 2340(c). This provision would also apply to REITs and most limited partnerships. *Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Valuation of Illiquid Direct Participation Program and Real Estate Investment Trust Securities on Customer Account Statements*, SR-NASD-97-12, Exchange Act Rel. No. 38451, SR-NASD-97-12, 1997 SEC LEXIS 691, at *1 (Mar. 27, 1997).

[21] In its order approving the proposed rule change, the SEC noted, "The Commission notes that the proposed rule change would codify FINRA's longstanding policy of applying certain regulatory requirements in NASD Rule 2810 to REITs." *Order Approving Proposed Rule Change*, Exchange Act Rel. No. 57803, SR-NASD-2005-114, 73 FR 27869 (issued May 8, 2008).

are not fair and reasonable, and requires firms to obtain certain specific information pertaining to the offering.[22]

The expansion into the sale of limited partnerships was a material change. Limited partnerships are illiquid investments.[23] Limited partnerships also may be direct participation programs, and are therefore subject to the same risks and requirements addressed in Rule 2810, as well as Rule 2340(c).[24]

As discussed below, Respondent's written supervisory procedures should have included specific procedures for supervision of the firm's business in the Four Products. The requirement for the establishment of specific written supervisory procedures for the Four Products also suggests that they are sufficiently different from other products that expansion into the sale of private placements constitutes a material change. The failure of Merrimac's written supervisory procedures to address the procedures with respect to the Four Products shows that the firm's supervisory procedures were not adequate to supervise the sale of the Four Products.

Any reliance on the March 2004 letter from a FINRA examiner that indicated that it was not necessary to file pursuant to Rule 1017 when brokers and assets moved from Allen Douglas is not a defense. The letter's conclusions were expressly based on the representation that nothing

[22] Reg. Notice 08-35 (July 2008).

[23] *J. Stephen Stout*, Exchange Act Rel. No. 43410, 2000 SEC LEXIS 2119, at *44, n.49, and *48, n.52 (Oct. 4, 2000); *Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers*, Exchange Act Rel. No. 43069; 17 CFR Parts 241 and 271, 2000 SEC LEXIS 1573, at *13, n.26 (July 24, 2000).

[24] Rule 2810(a)(9) defined a limited partnership as "an unincorporated association that is a direct participation program organized as a limited partnership whose partners are one or more general partners and one or more limited partners, which conforms to the provisions of the Revised Uniform Limited Partnership Act or the applicable statute that regulates the organization of such partnership." In a notice concerning the amendment of Rule 2810 and other rules, FINRA noted, "NASD Rule 2810(a)(4) defines 'direct participation program' as a 'program that provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution. …' This definition covers most limited partnerships and specifically excludes real estate investment trusts." *Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Valuation of Illiquid Direct Participation Program and Real Estate Investment Trust Securities on Customer Account Statements*, Exchange Act Rel. No. 42698, SR-NASD-00-13, 2000 SEC LEXIS 788 at *11, n.9 (Apr. 18, 2000).

would change at Merrimac, soon after the membership agreement had been issued without including the Four Products, and soon after Matthews had represented that plans to sell private placements had been deferred. It was unreasonable to conclude that the letter authorized Merrimac to engage in a business that had been excluded from the membership agreement after the examiner raised a number of questions concerning Merrimac's ability to conduct the business, and Merrimac's representation that the business plan had been changed to defer plans to conduct a private placement business.

The failure of FINRA staff to respond to Merrimac's November 2005 inquiries also is not a defense. The NAC has recently rejected a similar argument, stating, "We reject respondents' attempt to shift responsibility to FINRA."[25] Any reliance on FINRA's failure to respond was particularly unreasonable in light of the direction by a FINRA examiner in early 2005 to delete the private placements and limited partnerships from Merrimac's Form BD because the activities were not approved in the firm's membership agreement, which should have provided substantial evidence of FINRA's view. In fact, Matthews's second letter to FINRA recognized that private placements were not included in the membership agreement, and Thomes recognized that the firm was not permitted to sell private placements and limited partnerships, but mistakenly believed that the firm was not selling them.

The Hearing Panel finds that Respondent violated Rules 1017 and 2110 by violating its membership agreement.[26]

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[25] *Dep't of Enforcement v. FCS Securities*, No. 2007010306901, 2010 FINRA Discip. LEXIS 9, at *18 (N.A.C. July 30, 2010), citing *Dep't of Enforcement v. Am. First Assoc. Corp.*, No. E1020040926-01, 2008 FINRA Discip. LEXIS 27, at *17 (N.A.C. Aug. 15, 2008) (holding that respondent could not shift responsibility to FINRA even if he sought FINRA's advice and did not receive a response).

[26] A violation of a membership agreement is a violation of Rule 2110. *See Dep't of Enforcement v. Day Int'l Sec.*, No. C01020023, 2003 NASD Discip. LEXIS 57, at *12 (O.H.O. Dec. 30, 2003); *Kirlin Securities*, Exchange Act Rel. No. 61135, 2009 SEC Lexis 4168, at *59-60, n.81 (Dec. 10, 2009) (a violation of an SEC or NASD rule or regulation is also a violation of NASD Rule 2110).

V. Respondent Violated NASD Rules 3010 and 2110 by Failing to Establish and Maintain Adequate Written Supervisory Procedures for the Four Products and Variable Annuities

A. Facts Relevant to Causes 2 and 3 Concerning Written Supervisory Procedures for Sale of the Four Products and Variable Annuities

As noted above, Respondent sold substantial amounts of private placements, non-traded REITs, limited partnerships, and direct participation programs. Respondent's sales of variable annuities were also substantial, as much as 20% of its sales. Tr. 103, 246. Despite the substantial sales of these five products, its written supervisory procedures barely mentioned any of them, and did not include any specific procedures with respect to any of the five products. CX-2; Tr. 102 – 103, 107 – 108, 248.

Matthews explained that product-specific issues were supervised, but that the procedures were not codified in the firm's written supervisory procedures. Tr. 356 – 360. For example, he testified that although the written supervisory procedures contained nothing on due diligence on private placements, he conducted due diligence. Tr. 100 – 102, 356 – 357. Matthews also believed that it was less necessary to address issues concerning the sales of these five products because Merrimac's procedures required his approval for all transactions. Tr. 118 – 120; CX-2 at 6.

Matthews testified that he addressed issues of brokers' responsibility in continuing education, including the firm element and individual training. Tr. 101, 117. He preferred addressing the issues in continuing education to ensure that brokers read and understood the rules. Tr. 101, 354.

B. Respondent Violated NASD Rules 3010 and 2110 by Failing to Establish and Maintain Adequate Written Supervisory Procedures for the Four Products and Variable Annuities

NASD Rule 3010(b)(1) requires each member firm to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD." Merrimac violated Rules 3010 and 2110 by failing to establish written procedures to supervise the sale of the Four Products and variable annuities.

A firm's written supervisory procedures "document the supervisory system that the firm has established."[27] There are several reasons for requiring written supervisory procedures:

> Written procedures provide the personnel subject to the supervisory system, as well as those responsible for implementing it, a document that explains the supervisory system and their specific responsibilities. Written procedures also provide stability and continuity as personnel take on different responsibilities or leave the firm. In addition, senior management can use the written procedures to determine whether personnel are complying with the supervisory system by auditing compliance with the written procedures.[28]

FINRA recently cautioned firms concerning the necessity of establishing and maintaining reasonable supervisory procedures with respect to the sale of private placements. The Regulatory Notice reminded members that if a firm engages in Regulation D offerings, it must have supervisory procedures that are reasonably designed to ensure that the firm's personnel, including its registered representatives:

- engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
- perform the analysis required by NASD Rule 2310 [suitability];

[27] NTM 99-45, 1999 NASD LEXIS 20, at *4 (June 1999).

[28] *Id.* at *7.

- qualify their customers as eligible to purchase securities offered pursuant to Regulation D; and
- do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature.[29]

While Matthews asserted at the hearing that he supervised the firm's registered representatives carefully, actual supervision is not a substitute for having written supervisory procedures.[30] Nor is it a defense that he discussed the issues with the firm's representatives in continuing education. FINRA has made clear that the requirement for written supervisory procedures, while a part of a supervisory system, is a distinct requirement.[31]

Respondent also pointed to certain general standards for review of transactions in its written supervisory procedures. The procedures required prompt review and approval of every transaction, and a periodic suitability review of all customer accounts, but had no specific procedures with respect to the Four Products or variable annuities. CX-1 at 6, 7. However, "general reference materials are not sufficient written supervisory procedures …."[32] A member's written supervisory procedures must be tailored specifically to the firm's business.[33] Such general references are especially deficient here because of the nature of the securities that were not covered by the written procedures. They were governed by specific regulatory

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[29] Reg. Notice 10-22, at 7.

[30] During the continuing membership application process, the examiner specifically commented on the requirements for written supervisory procedures for the proposed private placement business, noting that the written supervisory procedures "should address how the firm will ensure that investors meet the subscription or suitability requirements as well as the firm's policies on concentration." CX-13 at 3.

[31] NTM 99-45, 1999 NASD LEXIS 20 (June 1999). Respondent was not charged with the failure to supervise the sale of these products, and the Hearing Panel makes no findings concerning the adequacy of the firm's supervision.

[32] *Dep't of Enforcement v. Respondent Firm*, No. C01040001, 2005 NASD Discip. LEXIS 47, at *24 (N.A.C. Sept. 6, 2005).

[33] *Dep't of Enforcement v. Respondent Firm*, 2005 NASD Discip. LEXIS 47, at *24.

requirements, did not trade on public markets, and had different characteristics from publicly traded equities.

By failing to establish, enforce, and maintain specific written supervisory procedures with respect to private placements, non-traded REITs, limited partnerships, direct participation programs, and variable annuities, Respondent violated NASD Conduct Rule 3010, and thereby violated Rule 2110.

VI. Respondent Willfully Violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Preserve All E-mails Related to Its Business as Such

Respondent's record retention practices for e-mails changed over the years. The Complaint alleges that violations occurred from 2004 until October 2007, but separates the alleged violations into two periods, based on the periods covered by examinations of the firm as well as changes in the firm's practices.

A. Respondent's E-mail Retention Practices

1. Respondent's E-mail Retention Practices, 2004 – October 2006

Respondent's representatives were not heavy users of e-mail. About 25 representatives used e-mail. About 17 of those used e-mail solely to receive commission runs and notices from the home office, and eight were more active users. There were few e-mails from clients even for those eight representatives. CX-8 at 2, 3; Tr. 411 – 412.

Until about the first quarter of 2005, most of the e-mails for Respondent's representatives were sent and received on the Allen Douglas server, because most representatives had been registered with both firms until late 2004. Tr. 299 – 300; CX-8. The parties presented no evidence of the record retention practices while the representatives used the Allen Douglas server.

After switching to its own server, Merrimac attempted to save its business-related e-mail on the server. In about October 2005, Thomes stopped the server from saving incoming e-mail due to a problem with excessive spam. He intended to stop saving the incoming e-mails only as a temporary solution, but forgot that he had done it until a FINRA examiner asked him during an examination about procedures for saving e-mails. Tr. 240 – 241, 299 – 301, 407 – 410.

When Thomes stopped saving the incoming e-mails on the server, he printed the e-mails that he believed Merrimac was required to save, attempting to comply with recordkeeping requirements. Tr. 303, 412. To determine whether to save an incoming e-mail, Thomes used a set of criteria that he developed to evaluate the importance of the e-mail. All e-mails from clients were saved. CX-8 at 3; Tr. 304, 428.[34]

Outbound e-mails continued to be saved on the server, where they were "queued up" until they were saved on a non-rewritable, non-erasable disk when a sufficient quantity had been accumulated to be worth creating a disk. Tr. 406 – 407. While the outgoing e-mails were stored on the server, they were erasable and rewritable. Tr. 302 – 303.

If a representative received an e-mail from an annuity or mutual fund company, the e-mail was considered to be spam and not saved, even if it was from one of the companies with which Merrimac dealt. If an e-mail contained information about their offerings, it was not considered worth saving because Merrimac retained hard copies of the document. Tr. 406 – 407, 473.

[34] During the 2006 examination, Thomes told the examiner that no incoming e-mails were saved. He did not state that some were printed and saved in client files. Tr. 240, 244 – 245. In its Wells submission in connection with this proceeding, Merrimac represented that it had stopped retaining incoming e-mails to which no response was made. CX-4. The discrepancy between these and later representations, including hearing testimony, that some incoming e-mails were printed and saved, was not explained. Resolving this issue would not affect the Hearing Panel's decision on whether there was a violation or on sanctions.

The operations department handled the retention of its e-mails. Tr. 305 – 306, 310. Operations department e-mails, including e-mails between Merrimac and the clearing firm or between the operations department personnel and representatives, typically were not saved. Attachments to operations department e-mails were printed and saved. Tr. 307 – 308, 447, 469; CX-8 at 3. If the operations department e-mails related to a client, such as a client's account statement, the attachment was printed and put into the client's file. Tr. 311. Merrimac did not save incoming e-mails that conveyed attachments because it considered the e-mails useless. For example, if the e-mail said, "[s]ee attached form," only the attachment was saved. CX-8; Tr. 306. A short e-mail from the clearing firm that said something like "[d]one" was not saved. Tr. 307 – 308, 447. Internal e-mails conveying attached files were also not saved because the files were saved on the server. Tr. 309 – 310; CX-8 at 2.

The result of saving e-mails in paper files was to make it difficult to obtain e-mails if one wanted to review e-mails covering a time period rather than those relevant to a specific client. If one wanted e-mails for a given time period, it would have been necessary to examine thousands of client and operational files. Tr. 311 – 312.

2. Respondent's E-mail Retention Practices, November 2006 – October 2007

The procedures for saving e-mail were different during the period covered by the second FINRA examination that led to the filing of the Complaint. Starting in about November 2006, all e-mail was saved and stored on a separate server, and was no longer printed. Tr. 312 – 313, 412 – 413, 462; CX-9. While the e-mail was on this server, it could have been altered or deleted. Tr. 220, 315 – 316. Merrimac used security measures to ensure that only Thomes had access to the server. Tr. 315, 413.

During this period, the e-mails were not non-erasable or non-rewritable until they were archived on a compact disk. Thomes planned to save the e-mails annually to a disk in a non-erasable, non-rewritable format. Tr. 220, 315 – 316, 413 – 414, 442. At the time of the FINRA examination, the system had been in use for about nine months. The e-mails were "queued up" on the server waiting to be archived on a compact disk, but none of the e-mails had been saved to a disk. Tr. 414.

In November 2007, Thomes sent a notice to FINRA, reporting Merrimac's use of electronic storage media. The letter stated that it was being sent "[p]ursuant to S.E.C. Rule 17a-4." CX-12; Tr. 317, 433. The firm had not sent a notification of its use of electronic storage before November 2007. Tr. 163 – 165.

B. Respondent Violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Maintain Adequate Books and Records with Respect to E-mails

NASD Rule 3110(a) provides:

> Each member shall make and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations and statements of policy promulgated thereunder and with the Rules of this Association and as prescribed by Exchange Act Rule 17a-3. The record keeping format, medium, and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.

Exchange Act Section 17(a)(1) requires broker-dealers to make, keep, and furnish such records of its operations as the SEC, by rule, prescribes as necessary and appropriate in the public interest and for the protection of investors. Under Section 17(a) and Exchange Act Rule 17a-4, these requirements encompass business correspondence, including electronic communications such as e-mails with outside parties and within the broker-dealer.[35]

[35] *vFinance Investments, Inc*., Exchange Act Rel. No. 62448, 2010 SEC LEXIS 2216, at *22 (July 2, 2010).

Rule 17a-4(b)(4) requires each broker-dealer to "preserve for a period of not less than 3 years, the first two years in an easily accessible place. … [o]riginals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public." The SEC has emphasized the importance of the records required by the rules as "the basic source documents" of a broker-dealer.[36] The recordkeeping rules are "a keystone of the surveillance of brokers and dealers by [SEC] staff and by the securities industry's self-regulatory bodies."[37]

Respondent's practices with respect to retention of e-mails from 2004 through October 2007 violated Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4, and therefore Respondent violated NASD Rules 3110 and 2110.

1. Respondent Violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Preserve All Business-Related Incoming and Internal E-mails from Early 2005 to October 2006

Respondent did not retain certain business-related incoming e-mails, and did not retain internal e-mails at all, from early in 2005 until October 2006. By failing to preserve these e-mails, Respondent violated Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4, thereby also violating NASD Rules 3110 and 2110.[38]

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[36] *Statement Regarding the Maintenance of Current Books and Records by Brokers and Dealers*, 4 SEC Docket 195 (Apr. 6, 1974).

[37] *Edward J. Mawod & Co.*, Exchange Act Rel. No. 13512, 1977 SEC LEXIS 1811, at *16 n.39 (May 6,1977) (citation omitted), *aff'd sub nom. Mawod & Co. v. SEC*, 591 F.2d 588 (10th Cir. 1979); *see also Electronic Storage of Broker-Dealer Records*, Exchange Act Rel. No. 47806, 2003 SEC LEXIS 1088, at *4 (May 7, 2003).

[38] There is insufficient evidence of Respondent's practices prior to early 2005 to determine whether a violation occurred. As noted above, until the first quarter of 2005, most of the e-mails for Respondent's representatives were sent and received on the Allen Douglas server. Tr. 299 – 300; CX-8. If the same violations had been found for 2004, the Hearing Panel's conclusions and sanctions would have been the same.

Exchange Act Rule 17a-4 requires brokers to preserve e-mails that relate to their "business as such" for a specified period.[39] Respondent did not retain internal e-mails or many incoming e-mails, including e-mails from its clearing firm, because it determined that the e-mails were not important. Rule 17a-4 does not distinguish between those e-mails the firm regards as important and those it regards as not worth saving. If the e-mails relate to the firm's business as such, they must be preserved. Respondent's failure to preserve e-mails conveying documents from mutual fund and annuity companies, including those with which Respondent dealt, also violated Rule 17a-4. Such e-mails also related to Respondent's business as such.[40]

By failing to preserve certain incoming e-mails relating to its business as such, and failing to retain internal e-mails, Respondent violated Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4, thereby also violating NASD Rules 3110 and 2110.

2. Respondent Violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Preserve Its E-mails in Non-Erasable, Non-Rewritable Form

Exchange Act Rule 17a(4)(f)(2)(ii)(A) requires that if records are kept electronically, they must be kept in a non-erasable, non-rewritable format.[41] Although Thomes planned to store all e-mails on non-erasable, non-rewritable disks on an annual basis, the records were erasable and rewritable while they were on Merrimac's server. Under his procedures, records were

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[39] For the purposes of Rule 17a-4, "the content of the electronic communication is determinative" as to whether that communication is required to be retained. *Reporting Requirements for Broker or Dealers Under the Securities Exchange Act of 1934,* Exchange Act Rel. No. 38245, 62 FR 6469, 6472 (Feb. 12, 1997). Thus, Respondent's failure to preserve genuine spam that was unrelated to its brokerage business was not a violation.

[40] In addition, Respondent's assessment of the importance of the deleted e-mails was flawed. The fact that a particular e-mail was sent or received could be important, for example, in determining whether or when a person associated with the firm, or the firm, had notice of the information contained in the attachment. Similarly, it was insufficient to save only paper copies of documents attached to e-mails that were received from issuers because it might be important for a regulator to know which representative received specific information, and when the information was received. If, for example, an examiner were looking at sales practices for the sale of a mutual fund, the examiner might want to know that a particular representative had information about the fund's performance or management at a time when the representative was recommending the fund to the firm's clients.

[41] *See Electronic Storage of Broker-Dealer Records*, Exchange Act Rel. No. 47806, 2003 SEC LEXIS 1088, at *2 (May 7, 2003).

rewritable and erasable for up to a year, and, in fact, some e-mails had been on the server for nine months at the time of the FINRA examination. Saving the e-mails for that length of time in an erasable, rewritable format violates Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4, and therefore also violates NASD Rules 3110 and 2110.[42]

It is not a defense that Thomes was the only one with access to the server, and that it allegedly had high security. Electronic media may be non-erasable and non-rewritable by either software or hardware protections, but protection by restricting access is insufficient. As the SEC stated in 2003:

> The Commission's interpretation [permitting protection by software rather than hardware] does not include storage systems that only mitigate the risk a record will be overwritten or erased. Such systems – which may use software applications to protect electronic records, such as authentication and approval policies, passwords or other extrinsic security controls – do not maintain the records in a manner that is non-rewriteable and non-erasable. The external measures used by these other systems do not prevent a record from being changed or deleted. For example, they might limit access to records through the use of passwords. Additionally, they might create a 'finger print' of the record based on its content. If the record is changed, the fingerprint will indicate that it was altered (but the original record would not be preserved). The ability to overwrite or erase records stored on these systems makes them non-compliant with Rule 17a-4(f).[43]

Respondent violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110 and NASD Rule 2110 by failing to preserve its e-mails in non-erasable, non-rewritable form.

[42] The Hearing Panel does not decide if there is some brief period during which, with proper protections, an e-mail might be retained in an erasable or rewritable format. If such a practice is permissible, it is clearly not permissible for the length of time during which Respondent maintained e-mails before saving them on non-rewritable, non-erasable disks.

[43] *Electronic Storage of Broker-Dealer Records*, Exchange Act Rel. No. 47806, 2003 SEC LEXIS 1088, at *7-8 (May 7, 2003).

3. Respondent Violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Maintain Its E-mails in an Easily Accessible Place

Exchange Act Rule 17a-4(b)(4) requires each broker-dealer to "preserve for a period of not less than three years, the first two years in an easily accessible place … originals of all communications received and copies of all communications sent … (including inter-office memoranda and communications) relating to its business as such. …"[44] Although "easily accessible" is not specifically defined, SEC statements on the requirement to furnish documents to the SEC promptly suggest that a broker-dealer should be able to supply documents maintained on-site or electronically the same day a request is made.[45]

By storing e-mails solely in client files from early in 2005 until at least October 2006, Respondent made it impossible to identify and segregate recent e-mails quickly, or to produce them quickly upon request from an examiner. Making a bank of file cabinets available to examiners does not constitute "easily accessible." Respondent violated Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4, and therefore also violated NASD Rules 3110 and 2110, by storing the paper copies of e-mails solely in its client files.

4. Respondent Violated Section 17(a) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Notify FINRA of Its Use of Electronic Media to Preserve Records

Prior to storing records electronically, FINRA member firms must notify FINRA that the records will be maintained on electronic storage media.[46] Respondent failed to notify FINRA prior to using the electronic storage media until November 2007. By storing records on

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[44] 17 C.F.R. § 240.17a-4(b)(4).

[45] *vFinance Investments, Inc*., 2010 SEC LEXIS 2216, at *24-25 ("Exchange Act Rule 17a-4(j) requires broker-dealers to 'furnish promptly' legible, true, and complete copies of records covered under Rule 17a-4 that are requested by the Commission. We have stated that, '[g]enerally, requests for records which are readily available at the office (either on-site or electronically) should be filled on the day the request is made.'").

[46] Exchange Act Rule 17a-4(f)(2)(i).

electronic storage media prior to providing notice to notify FINRA of its use of electronic storage media, Respondent violated Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4, thereby also violating Rules 3110 and 2110.

5. Respondent's Violations Were Willful

The definition of willfulness is very broad. Under the securities laws, willfulness means "intentionally committing the act which constitutes the violation," and does not require proof of an intent to violate the laws or rules.[47]

Respondent intentionally committed all of the acts that constituted the record-keeping violations. It intentionally failed to save certain incoming e-mails; intentionally failed to save internal e-mails; intentionally saved paper copies of documents only in client files; and intentionally maintained e-mails in an erasable and rewritable format. Under the standard for willfulness, the violations were willful.[48]

VII. Respondent Willfully Violated Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Make and Keep Current Blotters for Its Direct Application Mutual Fund and Variable Annuity Businesses

A. Respondent Did Not Maintain Purchase And Sale Blotters for Direct Application Mutual Fund and Variable Annuity Businesses

When the examiner requested blotters in the 2007 examination, Thomes explained that the firm did not have blotters for its direct application mutual fund and variable annuity businesses. Tr. 111 – 112, 159. The documents that were used to keep track of the information that should have been maintained on blotters were placed into individual customer folders and

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[47] *vFinance Investments, Inc*., 2010 SEC LEXIS 2216, at *48; *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000).

[48] In light of the Hearing Panel's finding that Merrimac's recordkeeping violations were willful, as alleged in the fourth and fifth causes of action, the Hearing Panel finds that Merrimac is statutorily disqualified. A firm is deemed to be subject to a statutory disqualification under Sections 3(a)(39)(F) and 15(b)(4)(D) of the Exchange Act if it is found in a proceeding by a self-regulatory organization to have willfully violated the federal securities laws.

marked with colored stickers to identify the type of document. Tr. 111. Merrimac maintained several hundred client files. Tr. 112. To examine such files, an examiner would have to go to file cabinets to pick out the original documents from the customer files, which would have made it very difficult to examine a sample during an examination. Tr. 159 – 160.

Respondent contended at the hearing that commission runs were blotters maintained by the firm. Merrimac typically received commission runs from issuers on a weekly basis. The documents, which were prepared by the issuers, showed the customer's name, the date of each transaction, the securities bought or sold, and the amount of the purchase or sale. They were typically prepared weekly because the mutual fund and annuity companies paid Merrimac weekly. Tr. 433 – 434, 438 – 440, 442; RX-10. Thomes could also obtain the commission runs online as needed, so if he had been asked for the information for a particular day, he could have obtained the information from the issuer. Tr. 440 – 441. Merrimac sold variable annuities for about 15 to 20 issuers, and sold about 30 mutual funds on a direct application basis. Tr. 441.

B. Respondents Willfully Violated Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110, and NASD Rule 2110 by Failing to Maintain Purchase and Sale Blotters for Its Direct Application Mutual Fund and Variable Annuity Businesses

1. Respondent Violated Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110 and NASD Rule 2110 by Failing to Maintain Blotters

Exchange Act Rule 17a-3 requires brokers to "make and keep current:"

> Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered. [49]

[49] 17 CFR § 240.17a-3(a)(1).

As the SEC has explained,

> The blotters or other records of original entry described in subparagraph (1) of Rule 17a-3 itemize each day's transactions in a format that facilitates posting to the general and subsidiary ledgers. Blotter records relating to securities transactions – e.g., daily purchase and sale blotters – should reflect all transactions as of the trade date and should be prepared no later than the following business day.[50]

Respondent admits that it did not maintain blotters in the traditional manner with respect to direct application mutual fund sales or variable annuity sales, but contends that the commission runs it received from the mutual fund and variable annuity companies satisfied the requirement to maintain blotters. The Hearing Panel rejects this argument, and finds that by failing to maintain blotters, Respondent violated Rule 3110, thereby violating Rule 2110.

Although the information that is required to be kept in a blotter was included in the commission runs, the availability and periodic downloads of the spreadsheets did not meet the requirements of the SEC rule. Respondent neither made the records nor kept them current, but relied on the issuers. The commission runs were received several days after the transactions occurred. They were not a daily record, and typically were prepared later than the following business day. In addition, the blotters were not maintained in an easily accessible place, as required by Rule 17a-4. They were not maintained as a unitary record or set of records, but scattered among client files, making review by regulators a burdensome task. Access to the records in customer files was very difficult. The ability to obtain records from an outside source also does not satisfy the requirement to "preserve" the blotters in an easily accessible place.

[50] *Statement Regarding the Maintenance of Current Books and Records by Brokers and Dealers*, Exchange Act Rel. No. 10756, 1974 SEC LEXIS 3290, at *3-4 (Apr. 26, 1974).

Respondent violated Section 17(a) of the Exchange Act and Exchange Act Rules 17a-3 and 17a-4 by failing to make and keep current blotters for its direct application mutual fund and variable annuity businesses, thereby violating NASD Rules 3110 and 2110.

2. Respondent's Failure to Maintain Blotters Was Willful

Respondent's failure to make and keep current blotters for Respondent's direct application mutual fund and variable annuity businesses was willful. Respondent intentionally failed to maintain the proper blotters, choosing instead to rely on commission runs received from the mutual fund and variable annuity companies to maintain the records that should have been kept on daily blotters.

VIII. Sanctions

The Hearing Panel considered each violation and determined appropriate sanctions. In arriving at the appropriate fine for each violation, the Hearing Panel considered Respondent's financial condition, as discussed below. In total, Respondent is fined $18,500.

A. Financial Considerations

While denying that sanctions are necessary, Respondent asked the Hearing Panel to consider its financial condition if the Hearing Panel were to decide that monetary sanctions are appropriate. Respondent presented evidence of its precarious financial condition, which the Hearing Panel considered in determining the appropriate sanctions.

FINRA's Sanction Guidelines ("Guidelines") set forth two General Considerations relevant to a respondent's financial condition. General Consideration #1 counsels, "Disciplinary sanctions are remedial in nature and should be designed to deter future misconduct and to improve overall business standards in the securities industry." In particular, it directs adjudicators, "Factors to consider in assessing whether sanctions should be proportionately reduced based on firm size could include: the amount of the firm's revenues; the financial resources of the firm; the nature of the firm's business; the number of individuals associated with the firm; the level of sales and trading activity at the firm. …" General Consideration #8 states, "When raised by a respondent, Adjudicators are required to consider ability to pay in connection with the imposition, reduction or waiver of a fine or restitution. Adjudicators are required to consider a respondent's bona fide inability to pay when imposing a fine or ordering restitution. The burden is on the respondent to raise the issue of inability to pay and to provide evidence thereof."[51]

Merrimac's chief executive officer, Stephen Pizzuti, accurately described the firm's financial situation as "bleak." Tr. 506. Merrimac lost brokers when the FINRA examiner told the firm that it was not authorized to sell the Four Products in 2007, and the bad markets that followed soon thereafter exacerbated the firm's problems. It has laid people off, cut personnel costs, and moved to inexpensive space. Tr. 506 – 507, 556 – 557. Matthews takes only a minimal salary because most of his salary has been used to compensate Merrimac's new chief compliance officer. Tr. 556 – 558. Thomes is receiving only half of his former salary. Tr. 580. The only other salaried person is a clerical employee. Tr. 581. Stephen Pizzuti takes virtually no money out of the firm. He has not been receiving commissions, and has been liquidating personal assets to cover his living expenses. Tr. 507 – 509, 532, 577.

The firm is in poor financial shape despite all of these measures. Merrimac generated total revenue of nearly $4 million in 2005, but revenue declined to about $2.8 million in 2007. Total revenue dropped by nearly a million dollars in 2008, and was down to $1.4 million in 2009. In the first quarter of 2010, Merrimac generated total revenue of $495,549. Stip. 4. For

[51] *Cf. Dep't of Enforcement v. FCS Securities*, No. 2007010306901, 2010 FINRA Discip. LEXIS 9, at *27 (N.A.C. July 30, 2010) ("We have imposed a fine below the lowest recommended fine for the late filing of FOCUS reports because of FCS's small size and limited revenue."); *Toney L. Reed*, Exchange Act Rel. No. 37572, 1996 SEC LEXIS 2208, at *5 (Aug. 14, 1996).

fiscal years 2007 – 2009, the firm lost money each year. RX-9 at 7, 29, 53. While it had net income of $18,951.20 in the fourth quarter of 2009, the firm lost $9,382.89 in the first quarter of 2010. RX-9 at 98, 105.

Over the last 2 years, its excess net capital fluctuated from about $1,000 to $20,000. RX-9 at 25, 49, 65, 72, 79, 86, 94,101. In its most recent FOCUS report, it reported slightly higher excess net capital of $39,631. CX-34. Almost two-thirds of the firm's cash consists of its deposit with its clearing firm, so the excess net capital does not represent available funds. Tr. 562, 575. The firm has no assets that can be sold, and it cannot borrow. Tr. 557 – 558. There are no funds available from Team Advisory, the parent company. Merrimac is Team Advisory's only asset, and its only source of revenue. Tr. 533, 571.

B. Other considerations

In September 2009, FINRA suspended Merrimac for one day for failing to pay its membership assessment fees. Stip. 6. In February 2006, Merrimac entered into a Letter of Acceptance, Waiver and Consent with FINRA wherein the firm, without admitting or denying any wrongdoing, agreed to a censure and a $5,000 fine for failing to maintain a blanket fidelity bond from December 2002 through February 2005, in violation of NASD Conduct Rules 3020 and 2110. Stip. 7.

The firm has changed its management structure to improve its compliance efforts. Despite its financial condition, it has brought in a chief compliance officer who worked for the State of Florida for 23 years. Matthews is now focusing on private placement and anti-money laundering procedures, and Stephen Pizzuti is chief executive officer. Tr. 496, 528.

C. Sanction for Violation of Membership Agreement

For membership agreement violations, the Guidelines recommend a fine of $2,500 to $50,000. Adjudicators may increase the fine by the amount of Respondent's financial benefit.

In egregious cases, the Guidelines recommend consideration of an expulsion. The principal considerations are (1) whether Respondent breached a material provision of the agreement; (2) whether Respondent breached a provision of the agreement that was particular to the firm; and (3) whether the firm had applied for, was in the process of applying for, or had been denied a waiver of a restriction at the time of the misconduct.[52]

The Hearing Panel considered a number of factors here. Respondent did not intentionally violate its membership agreement. It genuinely, if negligently, believed that it was not engaged in the sale of products that it was not authorized to sell.[53] Adding a line of business without FINRA review and approval is a material breach. "In instances when a member intends to add a line of business, staff experience has shown that this type of expansion is often a significant event that has an impact on the firm's supervisory and compliance infrastructure."[54] The list of approved types of businesses was a provision that was particular to the firm, but was not an express restriction.

Having considered all of the foregoing, including Respondent's financial situation, the Hearing Panel imposes a fine of $5,000 for Respondent's violation of NASD Rules 1017 and 2110.

D. Sanction for Failing to Establish and Maintain Adequate Written Supervisory Procedures for Private Placements, Variable Annuities, and Other Securities

For deficient supervisory procedures in violation of Rules 3010 and 2110, the Guidelines recommend a fine of $1,000 to $25,000. In egregious cases, the Guidelines recommend suspending the firm with respect to any or all relevant activities for up to 30 days, and thereafter

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[52] *Guidelines* at 47.

[53] *See* Principal Consideration #13, *Guidelines* at 7.

[54] NTM 00-73 at 569.

until the supervisory procedures are amended to conform to rule requirements.[55] The principal considerations are whether the deficiencies allowed violative conduct to occur or to escape detection, and whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance.[56]

Respondent's failure to have adequate written supervisory procedures was not egregious. There is no evidence that any violative conduct occurred as a result of the deficient written supervisory procedures, or that it was difficult to determine who was responsible for specific areas of supervision or compliance.

For failing to establish and maintain adequate written supervisory procedures for sales of the five categories of securities, in violation of NASD Rules 3010 and 2110, Respondent is fined $2,500.

E. Sanctions for Recordkeeping Violations with Respect to E-mail

The Guidelines recommend a fine of $1,000 to $10,000 for recordkeeping violations, or $10,000 to $100,000 in egregious cases.[57] In addition, the Guidelines recommend suspension of the firm from any or all activities or functions for up to 30 days, and a longer suspension or expulsion in egregious cases. The principal consideration is the nature and materiality of the missing information.[58]

The Hearing Panel finds that Respondent's violation with respect to e-mail retention was quite serious, but not egregious, and imposes a fine at the top of the range for non-egregious cases. Respondent did not flout the Rules, but failed to understand their requirements. The missing information was important, but the most important incoming e-mails, those from clients,

[55] Respondent's procedures have been amended as of August 2007. CX-3; Tr. 158.

[56] *Guidelines* at 109.

[57] *Guidelines* at 30.

[58] *Guidelines* at 30.

were retained. The failure to maintain the records in non-erasable, non-rewritable format while they were on the server is serious, but there is no evidence that any e-mails were actually lost by erasure or rewriting before they were saved to disks. The failure to provide notice to FINRA of the use of electronic media deprived FINRA of the opportunity to review Merrimac's record retention practices, and proper and timely notice might have prevented the other violations.

For failing to maintain adequate books and records with respect to communications by e-mail in violation of NASD Rules 3110 and 2110, Respondent is fined $10,000.

F. Sanction for Failing to Maintain Purchase and Sale Blotters for Direct Application Mutual Fund and Variable Annuity Businesses

The applicable Guideline is the same as for the e-mail violation, but the Hearing Panel considers this violation less serious. Although Respondent did not maintain a blotter, the information was available, but was not in an easily accessible place. The appropriate sanction is on the lower end of the recommended range. For failing to maintain purchase and sale blotters for its direct application mutual fund and variable annuity businesses, in violation of Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110, and NASD Rule 2110, Respondent is fined $1,000.

IX. Conclusion

For violating NASD Rules 1017 and 2110 by engaging in types of business not authorized by its NASD membership agreement, Respondent is fined $5,000. For failing to establish and maintain adequate written supervisory procedures for sales of certain types of securities, in violation of NASD Rules 3010 and 2110, Respondent is fined $2,500. For willfully failing to maintain adequate books and records with respect to communications by e-mail, in violation of Section 17(a) of the Securities Exchange Act of 1934, Exchange Act Rule 17a-4, NASD Rule 3110, and NASD Rule 2110, Respondent is fined $10,000. For willfully failing to make and keep current purchase and sale blotters for its direct application mutual fund and variable annuity businesses, in violation of Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3 and 17a-4, NASD Rule 3110, and NASD Rule 2110, Respondent is fined $1,000. In total, Respondent is fined $18,500.

Respondent is ordered to pay the costs of the hearing in the amount of $4,676.80, which includes a $750 administrative fee and the cost of the hearing transcript. The fine and costs shall be payable on a date set by FINRA, but not less than 30 days after this Decision becomes FINRA's final disciplinary action in this matter.

HEARING PANEL

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By: Lawrence B. Bernard
Hearing Officer

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