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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. 2008011684001 Hearing Officer – SNB **Extended Hearing Panel Decision** January 19, 2011

The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent: (1) violated NASD Rules 1017 and 2110 by violating an interim restriction imposed by FINRA pending review and approval of a Rule 1017 application; and (2) violated NASD Rules 1022 and 2110 by failing to register as a Financial and Operations Principal. Accordingly, the Complaint is dismissed.

Appearances

Howard L. Kneller, Esq., and Donald C. Sullivan, Esq., New York, NY, for Complainant.

James D. Sallah, Esq., Boca Raton, FL, and Mark David Hunter, Esq., Coral Gables, FL, for Respondent.

DECISION

I. Procedural History

On June 24, 2009, the Department of Enforcement ("Enforcement") filed a two-cause Complaint in this matter. The first cause of action alleges that Respondent violated NASD Rules 1017 and 2110 by violating an interim restriction ("Interim Restriction") imposed on [EI] ("EI" or "the Firm"), pending FINRA's review and approval of the Firm's Rule 1017 application.[1]

[1] The charge that Respondent violated Rule 2110 is based upon his alleged violation of Rule 1017. Complaint ¶ 24; *See Enforcement's Pre-Hearing Reply Brief* at 8.

The second cause of action alleges that Respondent violated NASD Rules 1022 and 2110 by failing to register as a Financial and Operations Principal ("FINOP").[2]

On July 20, 2009, Respondent filed an Answer requesting a hearing. On March 12, 2010, the Hearing Officer denied Respondent's motion for partial summary disposition as to the second cause of the Complaint, and granted Enforcement's motion to strike Respondent's eighth and ninth affirmative defenses alleging retaliation and bias by FINRA Staff ("Staff").

An extended hearing was held in Boca Raton, Florida, on April 6-8, 2010, and April 13-14, 2010, before a Hearing Panel that included a Hearing Officer, a former member of the District 9 and 10 Committees, and a former member of the District 7 and 10 Committees. Eleven witnesses testified at the hearing. Respondent testified on his own behalf and called one additional witness; nine witnesses testified on Enforcement's behalf. The parties offered numerous exhibits, which were entered into evidence.[3] The parties submitted post-hearing briefs on June 4, 2010.

II. Respondent

Respondent entered the securities industry in 1990, joining [RI] ("RI") as an in-house attorney and registering as a general securities representative.[4] He later moved to the RI Compliance Department and became the head of compliance and internal audit for a RI

[2] NASD consolidated with the member regulation and enforcement functions of NYSE Regulation in July 2007 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. See Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the Rules that were in effect at the time of Respondent's alleged misconduct. In addition, because Enforcement filed the Complaint after December 15, 2008, FINRA's procedural rules govern this proceeding. The applicable rules are available at www.finra.org/rules.

[3] Enforcement offered Complainant's Exhibits ("CX") 8-9, CX-13-14, CX-19, CX-21, CX-24, CX-57, CX-62-63, CX-66, CX-70-72, CX-75, CX-81-84, CX-86-87, CX-90-92, and CX-97-102, which were admitted without objection. Respondent offered Respondent's Exhibits ("RX") 89, RX-91, RX-94 and RX-97, which were also admitted without objection. The parties also offered Joint Exhibits ("JX") 2-16, and JX-18; JX 20-22. Tr. 1046-1048.

[4] CX-1; Tr. 790.

subsidiary broker-dealer, RSI.[5] He then opened the RI London office where he served until 2005.[6] After that, he served as a consultant for broker-dealers and was appointed as an independent consultant to firms as part of undertakings in SEC, NASD and state regulatory actions.[7]

On November 7, 2007, Respondent was hired to serve as the Chief Operating Officer ("COO") of EI, its affiliate, [JI]. ("JI"), and the parent company of both broker-dealers.[8] Respondent was registered with EI as a general securities representative beginning in December 2007, and as general securities principal beginning in January 2008.[9] He remained in these capacities until October 2008.[10] He was not registered with a FINRA member firm at the time of the hearing.

III. Discussion

A. Enforcement Did Not Meet its Burden to Show that Respondent Violated the Interim Restriction

The first cause of action charges that, by directing the mailing of negative response letters to Firm customers notifying them that their accounts would be transferred to the Firm's affiliate, Respondent violated the terms of an Interim Restriction imposed on EI.[11] Thus, the Complaint charges that Respondent violated the terms of the written restriction, but does not charge that his direction to send the negative response letters constituted an independent violation of just and equitable principles of trade.[12]

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[5] CX-1; Tr. 791-92.
[6] CX-1; Tr. 798-99.
[7] Tr. 800, 803-04.
[8] Tr. 69, 808-09.
[9] CX-1. In June 2008, Respondent registered as a Municipal Securities Principal and a Registered Options Principal.
[10] CX-1; Tr. 800.
[11] At the Hearing, Enforcement also asserted that there were misstatements in the negative response letters. *See Enforcement's Post Hearing Brief* at 8. However, because this was not charged in the Complaint, the Hearing Panel did not consider it as part of the alleged violations.
[12] *See* note 1.

The Interim Restriction arose as part of a Rule 1017 application.[13] Specifically, Respondent filed simultaneous Rule 1017 applications on behalf of EI and its affiliate, JI, on June 6, 2008.[14] EI applied for a transfer of assets pursuant to Rule 1017(a)(3).[15] EI proposed to transfer its representatives and customer accounts to JI, following which, it would file a Uniform Request for Broker-Dealer Withdrawal ("Form BDW") to withdraw from FINRA membership.[16] The application was made to the District 7 Office in Florida, where EI was located.[17]

JI applied for a material change in business operations pursuant to Rule 1017(a)(5).[18] Specifically, it proposed to expand its business operations to receive EI's representatives and customer accounts and increase its market making activities.[19] The application was made to the District 10 Office in New York, where JI was located.[20]

The Interim Restriction was contained in the June 27, 2008, Staff response to EI's Rule 1017 application.[21] Consistent with its authority under Rule 1017, Staff imposed an Interim Restriction which prohibited EI from "executing or consummating" a transfer of Firm assets, pending approval of the Rule 1017 application.[22] Staff also provided EI with Notice to Members 02-57, which explained the use of negative response letters to bulk transfer customer accounts.[23]

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[13] Rule 1017 requires FINRA members to file an application with the Department of Member Regulation for specified changes to its ownership, control, or business operations.
[14] CX-9, CX-92.
[15] CX-9; Tr. 148, 831-32.
[16] CX-9; Tr. 65-66, 72-23, 75, 153.
[17] CX-9.
[18] CX-92; Tr. 148.
[19] CX-92; Tr. 77.
[20] CX-92.
[21] JX-2.
[22] *Id.* Under Rule 1017, Staff may elect to impose interim restrictions on a firm within the first 30 days of a Rule 1017 application, consistent with the specific standards set forth in Rule 1014. Tr. 55, 63.
[23] JX-2 pp. 5-9, JX-19. As explained in NASD Notice to Members 02-57, negative response letters are sometimes used to obtain customer authorization to bulk transfer a customer's account without an affirmative response from the customer. The use of such letters may be appropriate in situations where a firm merges with another firm, among other reasons. Endnote 1 to the Notice states that "certain account transfers may require [FINRA] approval under Rules 1017."

On July 25, 2008, EI informed Staff of its plan to transfer customer accounts using negative response letters "upon approval of the application."[24]

From June through October 2008, there were numerous communications regarding EI's application. Beginning in September 2008, several major broker dealers failed, the credit markets were in turmoil, and the equity markets dramatically declined. During this time, EI's financial condition worsened.[25]

On or about October 9, 2008, Respondent directed EI staff to send negative response letters to customers, informing them that EI's registered representatives would transfer to JI, and customer accounts would also transfer to JI if the customers did not direct otherwise.[26] EI staff sent negative response letters to approximately 1,000 to 2,000 of EI's 7,000 customers.[27]

Enforcement argued that the mailing of the negative response letters equated to "executing or consummating" the transfer of assets, because it was a "key step necessary to commence the plan to transfer customer accounts."[28] Respondent asserted that the Interim Restriction prohibited EI from transferring customer accounts, but did not prohibit it from sending letters communicating its plan to transfer them.

The Interim Restriction was contained in Staff's letter to the Firm dated June 27, 2008. It provided:

> Based on the information submitted in the continuing membership application regarding the proposed changes to [EI] the following restriction has been placed on the broker/dealer: You and the Firm are hereby restricted from *executing or consummating* the proposed transfer of assets of the firm until such time as the

[24] JX-4.
[25] Tr. 184, 706-07.
[26] JX-10 pp. 4-5; Tr. 733, 940.
[27] Tr. 899, 906, 1018, 1023.
[28] *See Enforcement's Post Hearing Brief* at 18.

> questions posed in this and subsequent requests are fully responded to and FINRA approves the application (emphasis added).[29]

The Hearing Panel thus focused on the meaning of the restriction from "executing or consummating" the transfer of assets.[30] Upon Respondent's unopposed motion pursuant to Rule 9145(b), the Hearing Panel took official notice of the definitions of the terms "execute" and "consummate."[31] Specifically, "execute" is defined in Black's Law Dictionary as "to perform or complete (a contract or duty)," and in Merriam-Webster's Online Dictionary as "to carry out fully: put completely into effect." "Consummate" is defined in Black's Law Dictionary as "[c]ompleted; fully accomplished," and in Merriam-Webster's Online Dictionary as "finish, complete."[32] The Hearing Panel found these definitions to be reasonable.

Enforcement claimed that Respondent's mailing of negative response letters amounted to "executing or consummating" the transfer of customer accounts because it commenced the

[29] JX-2. Enforcement argued for the first time in its Reply to Respondent's Pre-Hearing Brief, that the Interim Restriction continued into the first sentence of the next paragraph, which provided: "Until such time as the Firm can demonstrate that it can meet the standards noted above, you are to continue operating the Firm in the same manner as it was operating before the proposed ownership change and you are responsible for all activities conducted and operational functions as its principal." However, because this sentence appeared in a separate paragraph rather than directly following the colon designating the Interim Restriction, and because the term Interim Restriction was stated in the singular, the Panel did not find that the Interim Restriction extended to the next paragraph. Given this finding, the Panel did not need to address Respondent's argument that Enforcement failed to provide him with adequate notice of this theory prior to the commencement of the hearing.

[30] When a phrase is unambiguous, it should be applied as written and not expanded or contracted by outside evidence. *See West Virginia Univ. Hospitals, Inc., v. Casey*, 499 U.S. 83, 98 (1991), citing *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989)(statutory interpretation).

[31] *See Respondent's Motion for Official Notice* filed on April 13, 2010; Tr. 755, 1046.

[32] *Id.*

execution of a plan to transfer the accounts.[33] However, the Interim Restriction did not include the term "commence" or other words to that effect.[34]

After careful consideration, the Hearing Panel concluded that the plain meaning of the Interim Restriction prohibited the transfer of assets, but not the "commencement of a plan" to transfer them.[35] The Hearing Panel found that the reference to "executing or consummating" prohibited the "carrying out fully" or "completing" of the transfer. Here, the preparatory step of sending a letter describing the planned transfer, which might occur days or weeks later, was not covered by the prohibition on executing or consummating the transfer of assets. Because Respondent did not carry out fully or complete the transfer of customer accounts,[36] the Hearing Panel dismisses the first cause of the Complaint.[37]

B. Enforcement did not Meet its Burden to Show that Respondent was Required to be Licensed as a Financial and Operations Principal

The second cause of action charges that Respondent violated NASD Rules 1022 and 2110 by acting as a FINOP without being registered as such. There is no dispute that the Firm

[33] Complaint ¶ 24.

[34] Enforcement argued that the Hearing Panel should endeavor to distinguish between the meaning of the terms "execute" and "consummate" in order to avoid rendering one of the terms meaningless, citing *The Travelers Indemnity Co. v. Dammann & Co., Inc.*, 2010 U.S. App. LEXIS 2497, *46 (3rd Cir. Feb. 5, 2010). This guidance, however, is premised upon the availability of a reasonable alternative meaning for the term at issue. *See, e.g., Moskal v. United States*, 498 U.S. 103 (1990) ("The principle [against mere surplusage] is sound, but its limitation ('if possible') should be observed. It should not be used to distort ordinary meaning. Nor should it be applied to obvious instances of iteration to which lawyers, alas, are particularly addicted . . . ." *Id.* at 120 (Scalia, J. dissenting). Here, Enforcement implied that 'execute' or 'consummate' should be construed to mean 'commence.' The Panel did not find this meaning to be a reasonable alternative to the ordinary meaning of the terms at issue.

[35] Even if the Hearing Panel were to accept Enforcement's argument that the commencement of a plan equated to executing or consummating the transfer of assets, Enforcement would need to establish that Respondent indeed had a *plan* to complete the transfer of accounts *without prior FINRA approval*. However, evidence offered at the hearing suggested otherwise. Respondent's October 9, 2008, letter flagged to EI's clearing firm that negative response letters had been mailed and EI's operations would terminate "upon approval by our regulatory authorities." JX-7. Thus, Respondent underscored to EI's clearing firm, which controlled the account transfers, that regulatory approval was a necessary step in EI's termination of operations and the associated account transfers. Moreover, the Hearing Panel found it unlikely that Respondent would highlight the need for regulatory approval if it was his plan to persuade the clearing firm to transfer customer accounts without such approval.

[36] Some EI customer accounts were transferred pursuant to positive responses, following FINRA Staff's approval of Jessup's Rule 1017 application. Tr. 620-621.

[37] The Hearing Panel's dismissal of this charge should not be read as an endorsement of Respondent's decision to send the negative response letters. The Hearing Panel did not address that issue; it simply found that sending the negative response letters did not violate the terms of the Interim Restriction.

had a designated FINOP during the period at issue. [AR] ("AR") served as the Firm's FINOP from November 2007 through February 2008.[38] [XP] ("XP") served in this capacity from January through October 2008, when most of the activities in this matter took place.[39] AR and XP testified that Respondent did not engage in FINOP activities.[40] Nonetheless, Enforcement asserted that Respondent's activities required him to register as a FINOP under Rule 1022.

Rule 1022 requires each member firm to designate a qualified FINOP. The Rule also lists a FINOP's duties.[41] Specifically, subsections (A)-(G) of Rule 1022(b)(2) and (c)(2) provide that a FINOP is a person whose duties include:

> (A) final approval and responsibility for the accuracy of financial reports submitted to any duly established securities industry regulatory body;
> (B) final preparation of such reports;
> (C) supervision of individuals who assist in the preparation of such reports;
> (D) supervision of and responsibility for individuals who are involved in the actual maintenance of the member's books and records from which the reports are derived;
> (E) supervision and/or performance of the member's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the [Securities Exchange Act of 1934];
> (F) overall supervision of and responsibility for the individuals who are involved in the administration and maintenance of the member's back office operations; or
> (G) any other matters involving the financial and operational management of the member.

The substance of the Rule has not changed since it was initially proposed in 1975.[42] The language of the Rule, particularly the reference in subsection (G) to "any other matters involving the financial and operational management of the member" is quite broad. Neither party offered

[38] Tr. 730, 736, 739. During the relevant time period, AR reported to JM, the Firm's CFO. Tr. 736.
[39] Tr. 359, 710. XP held an accounting degree and was also the Firm's CFO. Tr. 697, 714, 731.
[40] Tr. 703-05, 739.
[41] NASD Rule 1022 requires that persons who perform FINOP duties must qualify by first passing an examination; either the "Financial or Operations" (Series 27) or "Introducing Broker-Dealer//Financial and Operations" (Series 28). The type of registration that is required depends upon the net capital requirements of the member firm. SEC Rule 15c3-1(a). However, regardless of the type of registration, the activities triggering registration are the same. The Complaint alleges that for the first part of Respondent's tenure at EI, a Series 27 license was required, and for the latter part, a Series 28 license was required. Complaint ¶¶ 33, 35; Tr. 262-63.
[42] *See* SR-NASD-75-6; Exchange Act Rel. No. 11889 (Dec. 1, 1975), 40 FR 57533 (Dec. 10, 1975); SR-NASD-78-16, Exchange Act. Rel. No. 15883 (May 30, 1979), 44 FR 33203 (June 8, 1979).

any authority interpreting the Rule. This appears to be the first case charging that a principal of the firm was required to register as a FINOP when the firm already had a designated FINOP performing all of the enumerated duties. To assist in the understanding of the intended reach of the Rule, the Panel considered FINRA pronouncements as to the Rule's purpose.

There are several FINRA Notices to Members describing the purpose of the FINOP requirement. For example, FINRA has explained, the "purpose of requiring members to employ a [FINOP] is to protect investors and the public interest by helping to ensure that the [firm's] financial and operations personnel . . . have the training and competence needed to ensure the member's compliance with applicable net capital, recordkeeping, and other financial and operational rules."[43] Similarly, FINRA has stated that a FINOP's role is to "[ensure] investor protection by being responsible for the firm's compliance with applicable net capital, recordkeeping and other financial and operational rules."[44]

Thus, Rule 1022 and FINRA's later pronouncements emphasize that a FINOP's role is narrowly focused on financial reporting and associated record keeping functions; the FINOP license is characterized as a "Limited Principal" consistent with this. When viewed in this context, the phrase "the financial and operational management of the member" is limited to those operational functions that are directly in conjunction with the FINOP's financial responsibilities. Thus, the FINOP registration requirement is intended to assure that the person with responsibility for, and control over, the firm's financial reporting responsibilities has the requisite specialized financial and accounting knowledge necessary to discharge these responsibilities.

Here, EI's designated FINOPs, AR and XP, discharged the responsibilities enumerated in Rule 1022. They controlled EI's financial reporting responsibilities. They, and not Respondent,

[43] NTM 01-52.
[44] NTM 06-23.

prepared EI's net capital computations, FOCUS reports and other financial reports submitted to regulators; they resolved accounting issues such as the proper accruals of expenses and accounts payable determinations; and they supervised the three individuals who assisted in these responsibilities.[45] Therefore, as a threshold matter, Respondent did not engage in the fundamental responsibilities requiring FINOP registration.

Nonetheless, Enforcement asserted that Respondent was required to register as a FINOP. First, Enforcement pointed to evidence indicating that the Firm's FINOP reported to Respondent to establish that Respondent supervised the Firm's financial reporting responsibilities.[46] However, Rule 1022 cannot reasonably be read to require that anyone supervising a FINOP must also be a FINOP.[47] Otherwise, all Firm personnel in the FINOP's reporting line, up to the Chief Executive Officer, would be required to be a FINOP regardless of their actual responsibilities. Enforcement essentially conceded this point when it acknowledged that Respondent was not required to be FINOP simply because he served as the Firm's COO.[48]

Enforcement also pointed to several instances where Respondent engaged in written and oral communications regarding EI's financial matters, which, it claimed, required him to be registered as a FINOP. For example, in early April 2008, when Staff sent Respondent several letters and e-mails inquiring about EI's net capital calculations, Respondent answered these inquiries. In addition, on April 10, 2008, after FINRA determined that the Firm's net capital was deficient, Respondent notified the Securities and Exchange Commission.[49] Respondent also responded to FINRA's suggestion to him that the Firm terminate market making activities to

[45] Tr. 359, 655, 695, 703-04, 714-17, 732, 737-39.
[46] Tr. 480-81, 690.
[47] EI's Written Supervisory Procedures Manual stated that the COO and the FINOP had responsibility for approving net capital computations. CX-100. However, there was no evidence that Respondent exercised any authority over that function. In addition, XP credibly testified that Respondent did not do so. Tr. 704.
[48] *See Transcript of April 1, 2010, Final Pre-Hearing Conference*, p. 47.
[49] CX-50-63.

lower the Firm's net capital requirement.[50] Finally, in August 2008, Respondent met with the Firm's Board of Directors to discuss the Firm's precarious financial condition and whether the Firm should stay in business.[51] However, in each of these situations, there was no evidence that Respondent exercised any control over the accounting treatment of these matters or how they were reflected in the Firm's financial records.[52] In fact, some of Respondent's communications to Staff specifically indicated that he was relying upon the FINOP to provide financial information.[53] The Hearing Panel found that the FINOP requirement was not intended to preclude Respondent, as EI's COO, from engaging in discussions about issues which were of great significance to EI's continued viability. In fact, the Panel found that such communications were appropriate for a COO. The FINOP requirement is not intended to chill efforts by firm management to become educated about accounting issues or discuss them with others; these activities do not equate with an exercise of control over the Firm's financial reports or related financial functions.

Enforcement also claimed that Respondent's direction to mail negative response letters[54] indicated that he had "overall supervision of and responsibility for the individuals who are involved in the administration and maintenance of the member's back office operations" under subsection (F). However, the Hearing Panel found that the implementation of Respondent's decision to mail negative response letters did not establish his overall supervision and responsibility for the back office personnel, any more than the implementation of other business

[50] JX-8. Respondent discussed the Staff's suggestion with XP, who advised that it would not address the Firm's near term net capital issue. Tr. 890.
[51] Tr. 876-77.
[52] Tr. 703-05, 739, 890, 996-98.
[53] CX-50-51.
[54] Tr. 733.

decisions would.[55] Moreover, Respondent's instruction to send letters to customers did not involve those operational functions that are directly in conjunction with the FINOP's financial responsibilities.

Finally, Enforcement pointed to Respondent's involvement in the review of legal invoices[56] and preparation of an expense sharing agreement between EI and Jessup.[57] Again, however, Respondent did not determine the accounting treatment of the legal expenses, nor was there evidence that he was involved in the determination of how the implementation of an expense sharing agreement would be reflected on EI's financial reports.[58] The Panel found that Respondent was not required to be a licensed FINOP to engage in these activities, just as a firm's general counsel would not be required to be so licensed. These activities do not reflect an exercise of control over the Firm's financial reports or related financial functions.

In summary, the Hearing Panel found that none of Respondent's activities called for the specialized knowledge of a FINOP and did not demonstrate the responsibility and control over the Firm's financial reporting functions that is contemplated in the Rule 1022 FINOP registration requirement. For these reasons, Enforcement has failed to meet its burden to show that Respondent violated Rules 1022 and 2110 by failing to register as a FINOP. Therefore, the Hearing Panel dismisses the second cause of the Complaint.

IV. Conclusion

The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent: (1) violated NASD Rules 1017 and 2110 by violating an interim

[55] In fact, the Firm's Chief Compliance Officer testified that Respondent did not have direct involvement in back office operations. Tr. 420, 423.
[56] Enforcement offered testimony that Respondent reviewed legal invoices and in some instances, attempted to negotiate them. Staff interpreted this as withholding payables from the books of the firm.
Tr. 478.
[57] Tr. 282, 691-95, 726-27.
[58] Tr. 695.

restriction imposed by FINRA pending its review and approval of a Rule 1017 application; and (2) violated NASD Rules 1022 and 2110 by failing to register as a Financial and Operations Principal. Accordingly, the Complaint is dismissed.[59]

HEARING PANEL

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By: Sara Nelson Bloom
Hearing Officer

[59] The Hearing Panel has 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.