BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 7, Complainant, vs. Respondent 1 and Respondent 2, Respondents.	DECISION Complaint No. C07950054 Dated: April 7, 1999

Respondent was found to have violated the rule prohibiting the receipt of compensation for making a market in an issuer's securities. Another respondent was found to have omitted a material fact during a conversation with an NASD Regulation, Inc., examiner when he failed to disclose that he had resigned as the FINOP of a member firm. Held, findings and sanctions reversed and dismissed as to both respondents.

Respondent 1 and Respondent 2 appealed a 1998 decision of the District Business Conduct Committee for District No. 7 ("DBCC") for NASD Regulation, Inc. ("NASD Regulation"). The matter was also called for review by the National Adjudicatory Council ("NAC") as to Respondent 2.[1] For the reasons discussed below, we reverse and dismiss the action as to both Respondent 1 and Respondent 2.

[1] The NAC called this case for review as to Respondent 2 to examine the sanctions because they "appear[ed] relatively low in light of the alleged violation."

Background

During the period in question, Respondent 1 was registered as a general securities representative with Firm A, which had its main office in State A and had a branch office in State B.[2] Respondent 2 was registered as a financial and operations principal ("FINOP") and an options principal with Firm A.

Factual and Procedural History

The DBCC filed the complaint in this matter in 1995. The complaint was based upon information obtained during a routine examination of Firm A commenced in 1994. The complaint consisted of four causes. The first cause of action alleged that Firm A, acting through Respondent 1 and another individual, violated Conduct Rule 2110 in that it received varying amounts of consideration from at least six issuers for filing Form 211 Applications ("Form 211s") with the NASD to list each issuer's securities on the OTC Bulletin Board. The second cause alleged that Respondent 2 and another individual violated Conduct Rule 2110 by failing to disclose to NASD Regulation staff that he (Respondent 2) had resigned as Firm A's FINOP. In its third cause, the complaint alleged that Firm A violated Conduct Rules 2110 and 2710 in relation to certain proposed underwritings. The fourth and final cause of the complaint alleged that Firm A violated Conduct Rules 2110 and 3010 by failing to establish, implement and enforce adequate written supervisory procedures.

Only Respondent 1 and Respondent 2 have appealed this matter and are parties to the current proceeding. Accordingly, we limit our review to the allegations that relate to them, namely the first and second causes of action.

The DBCC hearing was held in 1997.[3] At the beginning of the first day, Respondent 1, through his attorney, moved to have the complaint dismissed based upon the findings of the United States Court of Appeals for the Tenth Circuit in General Bond & Share Co. v. SEC, 39 F.3d 1451 (10th Cir. 1994). Specifically, Respondent 1 argued that the NASD's policy against "pay to play" in the market-maker

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[2] The evidence introduced during the hearing indicates that Firm was registered with the Securities and Exchange Commission ("SEC") and was a member of the NASD. It commenced business in October 1988, and its principal place of business was located in State B. In or about May 1993, it relocated its principal office to State A but kept an office in State B. Firm conducted a general securities business, primarily selling securities listed on the OTC Bulletin Board. Firm ceased conducting business on or about February 24, 1994, and filed a broker/dealer notice of withdrawal, often referred to as a "Form BDW," in March 1994. Its NASD membership was canceled in May 1994.

[3] The DBCC hearing had begun on May 6, 1997, but had not been completed on that day. The hearing was recommenced on May 29, 1997, and was completed at that time.

context, enunciated in Notice to Members ("NTM") 75-16, cannot be enforced because it was not established pursuant to the proper rulemaking process. He further argued that NASD Regulation had acknowledged that it cannot enforce this policy in NTM 96-83, which proposed a new rule prohibiting such conduct.[4] Respondent 1 also noted that the new rule was merely a proposal and, in any event, could not be applied retroactively. Therefore, he argued that the allegations in the first cause of the complaint should be dismissed.

NASD Regulation staff responded by arguing that General Bond is binding only in the Tenth Circuit. Staff also argued that the Tenth Circuit erred in its decision. In particular, staff argued that NTM 75-16, which the Tenth Circuit determined to be a rule change, was merely a warning. Staff acknowledged that the rule proposal in NTM 96-83 was issued in response to General Bond, but staff argued that the proposed rule was simply an attempt to ensure nationwide enforcement of the NASD's continuing policy of prohibiting such conduct. After considering the arguments of the parties, the DBCC determined to deny the motion to dismiss and proceed with the hearing.

Respondent 2, through his counsel, also made a motion at the outset of the hearing to dismiss the complaint as it pertained to him. Respondent 2 argued that although the complaint alleged that he had failed to disclose to NASD Regulation staff that he had earlier resigned as Firm A's FINOP, he was never directly asked whether he had resigned. Staff responded that, although he was not asked if he had resigned, Respondent 2 misled staff by failing to disclose his resignation. After considering the motion, the DBCC denied it and proceeded with the hearing.

The parties introduced the testimony of a number of witnesses and submitted various forms of documentary evidence for consideration during the DBCC hearing. With regard to the allegations against Respondent 1, staff introduced evidence indicating that Firm A, through Respondent 1, had accepted payments from certain issuers to file Form 211s with the NASD to list each issuer's securities on the OTC Bulletin Board. Although Respondent 1 did not dispute that Firm A requested and received the fees in question, Respondent 1 argued that such fees were paid for "due diligence" reviews and were perfectly permissible.

As to Respondent 2, staff introduced the testimony of NASD Regulation staff examiner ("Examiner"). Examiner testified that, in late 1993 and early 1994, Firm A was experiencing financial difficulties, had ceased conducting a securities business and was without a FINOP. According to Examiner, he told Firm A's president that NASD Regulation staff would not approve Firm A to recommence business until it hired a FINOP. Examiner stated that he first met Respondent 2 on January 7, 1994, during a meeting in State A with Firm A's president, who introduced Respondent 2 as Firm A's new FINOP. Shortly thereafter, Firm A recommenced its securities business.

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[4] Notice to Members 96-83 was issued in December 1996.

On January 31, 1994, NASD Regulation began a routine examination of Firm A's State A office. At that time, Examiner noticed that Respondent 2 did not appear to be on the premises. Examiner testified that when he asked to speak to Respondent 2, Firm A's president told him that Respondent 2 had gone to State B for a long weekend. Examiner testified that Firm A's president subsequently informed him that Respondent 2 would be working out of Firm A's State B office. Examiner stated that he was unable to reach Respondent 2 at Firm A's State B office, but he did manage to contact him at his State B home in mid-February, approximately two weeks after the examination of Firm A's State A office had begun.

Examiner stated that during this mid-February telephone conversation he expressed concern to Respondent 2 regarding Respondent 2's absence from Firm A's main office in State A while the examination was being conducted and shortly before Firm A's FOCUS reports were due. Examiner testified that Respondent 2 responded by indicating that he would fly back to State A, although he did not give a specific date. (Respondent 2 denied ever telling Examiner that he was flying back to State A.) Examiner also stated that Respondent 2 never mentioned that he had resigned as Firm A's FINOP.

Respondent 2 eventually returned to State A, where he met with Examiner on February 23, 1994. At that meeting, Examiner told Respondent 2 that it appeared that Firm A was not meeting its net capital requirement. Respondent 2 responded by telling Examiner that he had resigned as Firm A's FINOP on January 20, 1994.

Staff argued that Respondent 2's failure to disclose that he had resigned as Firm A's FINOP during the mid-February telephone conversation with Examiner constituted a material and misleading omission, in violation of Conduct Rule 2110. Respondent 2 countered by emphasizing that he never refused to answer any of staff's questions, never answered falsely and never made any misrepresentations to staff. He further argued, and staff does not dispute, that he was never specifically asked during the telephone conversation whether he was still acting as Firm A's FINOP. Respondent 2 also stated that, at the time of the conversation in question, he presumed that Firm A had informed NASD Regulation about his resignation as FINOP. Finally, Respondent 2 noted that the NASD's rules required Firm A, not Respondent 2, to inform NASD Regulation of his resignation within 30 days of receiving notice of it, a statement with which NASD Regulation staff agreed.

On April 13, 1998, the DBCC issued its decision. The DBCC found that Respondent 1 had violated Conduct Rule 2110 for his role in Firm A's receiving consideration from six issuers for filing Form 211s with the NASD to list each issuer's securities on the OTC Bulletin Board, as alleged in the first cause of the complaint. The DBCC also found that Respondent 2 had violated Conduct Rule 2110 by not disclosing to an NASD Regulation staff examiner the fact that he had resigned as the Firm A's FINOP. The DBCC determined that Respondent 1 should be censured, barred, fined $20,000 and ordered to disgorge $12,500 to NASD Regulation. In addition, the DBCC determined that Respondent 2 should be censured, suspended in all capacities for 30 calendar days, barred as a FINOP with a right to reapply in three years and fined $7,500. This appeal and call for review followed.

Discussion

As indicated above, the current proceedings involve two different causes of action. We will review each cause separately as they relate to the remaining parties.

First Cause of Action - Receiving Consideration for Filing Form 211s. Respondent 1 argues on appeal, as he did below, that NASD Regulation cannot enforce the NASD's policy against market makers' taking payments to make markets without first submitting such policy to the SEC for approval. Staff disagrees.

In General Bond, the DBCC found, among other things, that General Bond violated Conduct Rule 2110 by accepting compensation for listing stock with the National Quotation Bureau, Inc. (referred to in the securities industry as listing in the "Pink Sheets"). The DBCC's findings were upheld by the National Business Conduct Committee ("NBCC"), predecessor to the NAC. Thereafter, General Bond appealed to the SEC.

On May 11, 1993, the SEC issued its decision in General Bond upholding the findings of violation. See In re General Bond & Share Co., 51 S.E.C. 411 (1993). The SEC noted that market makers are normally compensated by trading for their own accounts. Id. at 413. When listing stock in the "Pink Sheets," market makers are typically concerned with the security's liquidity and intrinsic value. Id. The SEC found that these were not the motives of General Bond. Instead, General Bond was motivated by the receipt of fees from the issuers. Id. at 413-14. General Bond had argued that NTM 75-16 established a new rule which had to be submitted to the SEC and approved prior to its implementation. Id. at 414. The SEC rejected this argument. First, the SEC noted that Conduct Rule 2110 "sets forth an elastic standard intended to encompass a wide variety of conduct that may operate as an injustice to investors or other participants in the marketplace." Id. The SEC then referred to NTM 75-16 as a warning to members and further referenced a No-Action letter that the SEC had issued to a broker/dealer in 1973 containing similar language. Id. at 415 (citing Monroe Securities Inc., SEC No-Action Letter (Pub. Avail. June 4, 1973)).

General Bond appealed the SEC's decision to the Tenth Circuit. The Tenth Circuit, in General Bond & Share Co. v. SEC, 39 F.3d 1451 (10th Cir. 1994), agreed with General Bond that NTM 75-16 was a "rule change" which should have been submitted to the SEC for approval. Because NTM 75-16 was not filed with the SEC, the Tenth Circuit concluded that the notice could not be enforced against General Bond and dismissed the charges.

Respondent 1 argues, consistent with the Tenth Circuit's ruling in General Bond, that NASD Regulation cannot enforce NTM 75-16 against member firms without going through the rulemaking process and obtaining SEC approval. NASD Regulation staff argues that it has been a long-standing position of the NASD that "pay to play," or what might more appropriately be described as "pay to list," is prohibited and that General Bond does not prevent enforcement of this prohibition.

Staff claims that member firms were first warned about the "pay to list" prohibition in NTM 75-16. In NTM 75-16, the NASD cautioned members that the practice of accepting payment to make a market in an issuer's securities "may be prohibited under existing laws." The NASD further indicated in NTM 75-16 that payments by an issuer to a market maker would probably be viewed as a conflict of interest for a member making a market in that issuer's securities. Finally, the NASD warned members that "any arrangement whereby a member charges an issuer a fee for making a market or accepts an unsolicited payment from an issuer whose securities the member makes a market in raises serious questions under the anti-fraud provisions of the federal securities laws." NTM 75-16. Staff also cites to NTM 92-50, published in October 1992, which is a comprehensive guide regarding procedures for compliance with SEC Rule 15c2-11 and Schedule H, Section 4 to the NASD By-Laws (now known as Marketplace Rule 6740).[5] NTM 92-50 states, "A market maker cannot accept any form of compensation, including cash [or] securities . . . for the purposes of making a market, to cover out-of-pocket expenses for making a market, or for submitting an application to make a market in an issuer's securities." (emphasis added).

In addition, staff argues that the Tenth Circuit's decision in General Bond should not be followed. Staff reasons that the decision is not binding outside of the Tenth Circuit's appellate jurisdiction, that the Tenth Circuit mischaracterized NTM 75-16, that application of the decision leads to conflicting results and that General Bond can be distinguished because here respondent should have been on notice that his conduct was improper.

We begin our analysis by noting that, as a matter of federal law, the General Bond decision is binding precedent only in the Tenth Circuit. See Georgia Dept. of Med. Assist. v. Bowen, 846 F.2d 708, 710 (11th Cir. 1988) (noting that an agency of the United States is not required to accept an adverse determination by one circuit court as binding throughout the country) (citing Railway Labor Executive Ass'n v. ICC, 784 F.2d 959, 964 (9th Cir. 1986)). Moreover, since the conduct in this matter occurred in the Eleventh and Ninth Circuits, the General Bond decision is not directly controlling. See Generali v. D'Amico, 766 F.2d 485, 489 (11th Cir. 1985) (stating that the authority of one circuit is not binding upon another circuit).[6]

We also agree with the DBCC and staff that it has been a long-standing NASD policy that acceptance of compensation to make markets is improper. Indeed, in reaction to the General Bond

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[5] These are the rules which require members to (1) gather information regarding an issuer prior to submitting a quotation, (2) submit such information to the NASD and (3) consider certain factors before establishing a quotation.

[6] Even the Tenth Circuit has held that decisions of other circuits are not binding on it. FDIC v. Daily, 973 F.2d 1525 (10th Cir. 1992)(citing United States v. Carson, 793 F.2d 1141, 1147 (10th Cir.), cert. denied, 479 U.S. 914 (1986)).

decision, the NASD proposed a new rule specifically outlawing this type of conduct. The proposed rule became effective on July 3, 1997, and is now listed as Conduct Rule 2460.[7]

Although we continue respectfully to disagree with the Tenth Circuit's decision in General Bond, we recently determined that, for purposes of national consistency in enforcement policy, the holding in General Bond should be followed in NASD disciplinary actions involving "pay to list" practices occurring prior to July 3, 1997, the effective date of Conduct Rule 2460. In In re Escalator Secs., Inc., Complaint No. C07950049 (NBCC Dec. 31, 1997), the complaint alleged, and the DBCC found, that respondents accepted compensation from issuers to list the issuers' stock in violation of Conduct Rule 2110. On appeal, the NBCC dismissed this cause of action. In response to the DBCC's contention that General Bond was not controlling because the conduct occurred in the Eleventh Circuit, the NBCC stated:

> We disagree with the DBCC's premise that the Tenth Circuit's decision in General Bond is not controlling precedent. Given that the Tenth Circuit is a reviewing body and is the only circuit that has decided this issue, we find its decision in the General Bond case to be controlling.

Escalator, supra, at 3.

Here, staff argues on appeal that we should simply disregard Escalator. We decline staff's invitation to expressly or implicitly overturn our own, recent precedent. To the extent that the holding in Escalator is in any manner ambiguous, we now make clear that, for purposes of national consistency in enforcement, we have determined that it is appropriate to follow General Bond on a national basis, although we are not required to do so outside of the Tenth Circuit. Accordingly, the first cause of action is reversed and dismissed as to Respondent 1.

Second Cause of Action - Material Omission. The second cause of the complaint alleged that, in an interview conducted by an NASD Regulation staff examiner in mid-February 1994, Respondent 2 failed to disclose that he had resigned as Firm A's FINOP on January 20, 1994, in violation of Conduct Rule 2110.

The NASD Regulation staff examiner, Examiner, testified that he called Respondent 2 at his home in State B in mid-February 1994. Examiner testified that, during the conversation, he reminded Respondent 2 that Firm A's FOCUS report was due, told Respondent 2 that Firm A's auditors were

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[7] As indicated in NTM 97-46, Conduct Rule 2460 prohibits members and associated persons from accepting any payment or other consideration from an issuer to publish a quotation, act as market maker or submit an application to list a security. Conduct Rule 2460, however, does not apply retroactively to the conduct at issue. See, e.g., In re Edward N. Antoian, Complaint No. C07940049 (NBCC Mar. 8, 1996).

conducting their year-end audit and advised him that both NASD Regulation and the SEC were conducting examinations of Firm A. Examiner further testified that he asked Respondent 2 why he was in State B and not in State A at Firm A's main office in view of these circumstances. According to Examiner, Respondent 2 then indicated that he would return to State A.

Respondent 2 argues that he never lied about his exact relationship with Firm A during the telephone conversation with Examiner and that he was never expressly asked whether he was still Firm A's FINOP. Although Respondent 2 admitted that Examiner had asked him whether he was associated with Firm A, Respondent 2 maintains that his reply in the affirmative was truthful because, at that time, he remained associated with Firm A as an options principal. Respondent 2 also states that he presumed that Firm A had already notified NASD Regulation of his resignation as FINOP and that he was not trying to be misleading.

We cannot find, on the basis of the record, that Respondent 2 failed to act in accordance with high standards of commercial honor and just and equitable principles of trade, in violation of Conduct Rule 2110. One can reasonably infer that Respondent 2 misled Examiner, but one can just as reasonably accept Respondent 2's assertion that he assumed that Firm A had informed Examiner that Respondent 2 was no longer the FINOP. Because a new FINOP was not in place, Respondent 2 could have been under the impression that Examiner wanted to interview him, not as the current FINOP, but as the person most knowledgeable about Firm A's financial operations. Nothing in the record clearly supports one inference over the other. Given the reasonableness of both inferences, therefore, we cannot conclude that Respondent 2 violated Conduct Rule 2110.

Furthermore, to find Respondent 2 in violation of the rules, we would have to assume, without any clear basis in the record, that he knew that Examiner believed him to be the FINOP at the time of the call and that he had a duty to disclose the fact of his resignation. The evidence does not support those assumptions. Accordingly, we reverse and dismiss the second cause of action against Respondent 2.

Conclusion

In light of the foregoing discussion, this action is reversed and dismissed as to both Respondent 1 and Respondent 2. In addition, the sanctions imposed by the DBCC against both are reversed and dismissed.

On Behalf of the National Adjudicatory Council,

Senior Vice President and General Counsel