

PLEASE NOTE THE LATER CASE HISTORY OF THIS DECISION FOLLOWING THE TEXT OF THE DECISION.

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of
the Association of

X

as a

General Securities Representative

with

The Sponsoring Firm

Redacted Decision

Notice Pursuant to
Section 19(d)
Securities Exchange Act
of 1934

Decision No. SD98009

This matter involves the application for X¹, a person subject to a statutory disqualification, to become a registered representative of the Sponsoring Firm, a member firm located in New York. A hearing in the matter was held before a subcommittee of the Statutory Disqualification Committee ("SD Committee") of the National Adjudicatory Council ("NAC") of NASD Regulation, Inc. ("NASD Regulation"). X appeared and was accompanied by his counsel and the proposed supervisor ("the Proposed Supervisor"), Chief Executive Officer ("CEO") of the Sponsoring Firm.

X is subject to a statutory disqualification as a result of a 1997 injunction ordered by a United States District Court based on a complaint filed by the Securities and Exchange Commission ("SEC" or "Commission") for violations of Section 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 13b2-1 and 13b2-2 thereunder.² Without admitting or denying the allegations, X consented to the order of injunction and \$37,500 civil penalty. Specifically, X was enjoined from:

¹ The names of the Statutorily Disqualified individual, the Sponsoring Firm, the Proposed Supervisor, and other information deemed reasonably necessary to maintain confidentiality have been redacted.

² See Letter dated February 23, 1998 from NASD Regulation to the Sponsoring Firm.

" . . . knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record, or account . . . in violation of Section 13(b)(5) of the Exchange Act . . .;"³ and

" . . . directly or indirectly, falsifying, or causing to be falsified, any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act . . . in violation of Rule 13b2-1;"⁴ and

" . . . (a) making or causing to be made a materially false or misleading statement, or (b) omitting to state, or causing another person to omit to state, any material fact . . . to an accountant in connection with any audit or examination of the financial statements of an issuer, or preparation or filing of any document with the Commission . . . in violation of Rule 13b2-2."⁵

The injunction was based on conduct that occurred while X was President, CEO, and a director of Company A, a shoe and handbag company where he was employed from 1978 to 1993. The SEC complaint alleged that beginning in 1992, with X's knowledge, Company A's operations manager submitted to a lender customer sales invoices for unshipped goods pursuant to a factoring agreement, which permitted Company A to borrow funds based on a percentage of outstanding accounts receivable. Contrary to generally accepted accounting principles ("GAAP"), in 1992 and early

³ Section 13(b)(5) of the Exchange Act prohibits persons from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record, or account described in Section 13(b)(2). Section 13(b)(2) requires, in part, that certain issuers devise and maintain a system of internal accounting controls which provides reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") or any other criteria applicable to such statements.

⁴ SEC Rule 13b2-1 prohibits persons from directly or indirectly falsifying, or causing to be falsified, any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act. Section 13(b)(2)(A) requires certain issuers to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect their transactions and the dispositions of their assets.

⁵ SEC Rule 13b2-2 provides, in part, that no director or officer of an issuer shall directly or indirectly make or cause others to make a materially false or misleading statement to an accountant in connection with any audit or examination of the required financial statements of the issuer, or with the preparation or filing on any document required to be filed with the Commission.

1993, Company A's books and records reflected approximately \$1.2 million of revenue for which goods had not yet been shipped. Company A's accounting records and financial statements were presented to the company's independent auditors in connection with its fiscal year-end audit. In 1992, Company A filed with the Commission an S-1 registration statement for a \$3.5 million rights offering. When Company A's independent auditors learned of the "prebilling," it resigned from the audit and refused to issue the audit report. In 1993, Company A withdrew the S-1 registration statement.

The NASD Regulation Department of Member Regulation ("Member Regulation") received the Sponsoring Firm's completed MC-400 application on March 11, 1998. On May 13, 1998, Member Regulation requested that the Sponsoring Firm submit specific supervisory procedures that would be followed if X were permitted to be registered with the Sponsoring Firm. By letter dated May 13, 1998, the Proposed Supervisor proposed the following: (1) X would work under the supervision of the Proposed Supervisor or another general securities principal who had at least the same number of years of supervisory experience as the Proposed Supervisor, and X would either share an office with or sit next to the general securities principal; (2) all telephone calls would be monitored by the Proposed Supervisor or the assigned general securities principal; (3) all facsimiles that X prepared would be approved by either the Proposed Supervisor or the general securities principal assigned to X before being transmitted to clients; (4) all client correspondence would be approved by the Proposed Supervisor or the general securities principal assigned to X; (5) all customer orders would be approved by the Proposed Supervisor or the general securities principal assigned to X; (6) all customer requests for checks or transfers would be approved by the Proposed Supervisor or the general securities principal assigned to X; and (7) all customer statements would be reviewed by the Supervisor.

By letter dated May 19, 1998, Member Regulation advised the Sponsoring Firm that it would recommend approval of X's association with the Sponsoring Firm. Member Regulation recommended, however, that the Sponsoring Firm's supervisory procedures be amended to establish clearly that the Proposed Supervisor would be responsible for supervising X, and to name another general securities principal who would be responsible in the Proposed Supervisor's absence. Member Regulation also recommended that the Sponsoring Firm be required to follow these additional supervisory procedures: (1) that X conduct business on behalf of the Sponsoring Firm only from the office where the Proposed Supervisor is physically located as is represented on the MC-400; (2) that the specific steps of heightened supervision of X by the Supervisor be written and incorporated into the Sponsoring Firm's written supervisory procedures; (3) that for a 12-month period the heightened supervision of X by the Proposed Supervisor include, at a minimum, review and approval of any transaction or other business on behalf of one of the Sponsoring Firm's customers when X serves as the Sponsoring Firm's representative; (4) that X be prohibited from assuming any primary responsibility or authority over any of the Sponsoring Firm's books and records; (5) that X be prohibited from managing or supervising any aspect of the Sponsoring Firm's business or its employees; (6) that approval be limited to permitting X to act only in a registered representative capacity.

The Sponsoring Firm is a broker/dealer engaged in retail trading of listed securities. It has been a member of the NASD since 1995, and according to its MC-400 application, it has 20 registered representatives and six registered principals. The Sponsoring Firm proposes to employ X as a registered representative to sell securities and to analyze investment banking deals. The Sponsoring Firm proposes that X would be supervised by the Proposed Supervisor, who has known X for the last 15 years. The Proposed Supervisor has been a registered securities principal since 1996, and is a Certified Public Accountant with 20 years experience. The Proposed Supervisor currently is the Sponsoring Firm's compliance officer, and he has been in the securities industry for approximately two and a half years. The Sponsoring Firm employs no other individuals who are subject to statutory disqualification. The Sponsoring Firm's 1996 examination resulted in a finding of "forward without action," and its 1997 examination resulted in a Letter of Caution for deficiencies related to NASD Rule 1120.⁶ Neither the Proposed Supervisor nor the Sponsoring Firm has prior disciplinary history.

At the hearing, the Sponsoring Firm agreed to the additional supervisory procedures recommended by Member Regulation.⁷ The Proposed Supervisor testified that Employee 1 will be X's supervisor in the Proposed Supervisor's absence. Employee 1 is a general securities principal of the Sponsoring Firm and has not been the subject of any disciplinary action or customer complaint. We take official notice of Employee 1's Central Registry Depository ("CRD") record which confirms such.⁸

After a careful review of the entire record in this matter, we deny the application for X's association with the Sponsoring Firm as a registered representative. In determining to deny the application, we have considered that the activity for which X was enjoined is serious. We also note that the injunction is only a little over a year old. We thus conclude that even with the supervisory procedures outlined above, X should not be permitted association with the Sponsoring Firm as a registered representative.

⁶ At the hearing, the Supervisor testified that the 1997 deficiency related to the Sponsoring Firm's procedures manual and that the deficiency has since been corrected.

⁷ X testified that he has paid the \$37,500 civil penalty.

⁸ Employee 1's CRD record indicates that he qualified by examination as a general securities principal in 1996, and became registered with the Sponsoring Firm as such in 1997.

Accordingly, we do not believe it is appropriate, given proper regard for the public interest and protection of investors, to allow X to become associated with the Sponsoring Firm.

On Behalf of the National Adjudicatory Council,

Alden S. Adkins, Senior Vice President and General Counsel

LATER CASE HISTORY:

X appealed this decision to the SEC. After its review of the matter, the Commission set aside the action taken by NASD Regulation in denying the application of the Sponsoring Firm to continue its membership if it associates with X.

The Commission concluded that the injunction imposed on X did not render him subject to a statutory disqualification within the meaning of the Exchange Act and the NASD By-Laws. The Commission stated that Section 15A(g)(2) of the Exchange Act provided that a registered securities association may "bar from becoming associated with a member any person, who is subject to a statutory disqualification." Sections 3(a)(39) and 15(b)(4) of the Exchange Act include within the definition of "statutory disqualification" any injunction that enjoins conduct or a practice in connection with the purchase or sale of a security. The Commission found that the permanent injunction imposed on X did not enjoin conduct or a practice "in connection with" the purchase or sale of a security.

The Commission further stated that the record in this action did not support a conclusion that false or misleading information had reached the public as a result of X's actions. The Commission noted that Company A had filed the S-1 registration statement in December 1992 for a proposed public offering that contained financial information on the company only through October 31, 1992, before any of the questionable accounting practices began. That registration statement was withdrawn in April 1993. Although X allegedly transmitted tainted books and records to the Company A's independent auditor, the auditor's resignation from the company's January 31, 1993 year-end audit, without issuing an audit report, had prevented the incorporation of any inflated revenue figures into a public filing with the Commission.

The Commission rejected X's argument that the injunction had arisen from a "bookkeeping violation" which should not subject him to a statutory disqualification. In rejecting this "sweeping generalization," the Commission noted that a failure to keep accurate books and records properly may form the basis for an injunction that results in the prohibition of conduct in connection with the purchase or sale of a security. Since the facts in this record, however, indicated that X's conduct did not result in the filing or dissemination of false or misleading information, the Commission concluded that the permanent injunction imposed on X did not operate as a statutory disqualification. Accordingly, the Commission set aside the action of NASD Regulation and directed that X be permitted to associate with the Sponsoring Firm.