

**NASD REGULATION, INC.  
OFFICE OF HEARING OFFICERS**

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|----------------------------|---|-------------------------|
| DEPARTMENT OF ENFORCEMENT, | : |                         |
|                            | : |                         |
| Complainant,               | : | Disciplinary Proceeding |
|                            | : | No. C3A970009           |
| v.                         | : |                         |
|                            | : | Hearing Officer - JMF   |
| W.B. McKEE SECURITIES,     | : |                         |
| (BD # 27968)               | : |                         |
|                            | : |                         |
| WILLIAM B. McKEE,          | : | <b>DECISION</b>         |
| (CRD # 1811305)            | : |                         |
|                            | : |                         |
| ROBERT J. TRASK,           | : | July 16, 1998           |
| (CRD # 2509073)            | : |                         |
|                            | : |                         |
| GARY J. SHERMAN,           | : |                         |
| (CRD # 822819)             | : |                         |
|                            | : |                         |
| RONALD V. JOHNSTON         | : |                         |
| (CRD # 260685)             | : |                         |
| San Diego, CA              | : |                         |
|                            | : |                         |
| and                        | : |                         |
|                            | : |                         |
| JOHN M. GERSTEN            | : |                         |
| (CRD # 221400)             | : |                         |
|                            | : |                         |
| Respondents                | : |                         |

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Digest

The Department of Enforcement filed a Complaint alleging that W.B. McKee Securities, Inc. ("WBSI"), acting through Respondent Ronald V. Johnston, violated NASD Conduct Rule 3010 by failing to establish, maintain and enforce written procedures

to supervise the businesses in which it engaged, and the activities of its associated and registered persons in a manner reasonably designed to achieve compliance with applicable laws, rules and regulations in connection with nine specific activities; that Respondent violated Rule 3010(d) and 2110 in that the firm, acting through Respondent Johnston, failed to establish and maintain written procedures for the review and endorsement by a registered principal, on an internal record, of transactions evidenced by subscription agreements and failed to evidence the review of customer purchases by subscription agreement in an offering; and that the firm, acting through Respondent Johnston, violated Rule 2110 by imposing miscellaneous and postage charges totaling \$5.00 per transaction in connection with an initial public offering that were not disclosed in the prospectus.

The Hearing Panel found that Respondent Johnston violated Rule 3010 in connection with the firm's written policies and procedures relating to seven of the nine specifically alleged deficiencies contained in Cause Five, namely: not including an accurate and current designation of supervisors and principals; not including provisions for the handling of cash receipts; not including provisions for the review or inspection of branch offices; not including provisions for the supervision of sales activities reasonably designed to achieve compliance with the penny stock rules; not addressing the reports that the firm's Compliance Registered Options Principal submits to senior management; and not including provisions relating to uncovered short options transactions. The Hearing Panel found that Respondent Johnston was not responsible for the firm's policies and procedures relating to the review of customer subscription agreement transactions or for the undisclosed miscellaneous postage and handling fees. The Hearing Panel determined that the appropriate sanction was a letter of caution and also assessed costs against

Respondent Johnston.

## Appearances

Jacqueline D. Whelan, Esq., Regional Counsel, Denver, CO (Rory C. Flynn, Esq., Washington, DC, Of Counsel) for the Department of Enforcement.

Peter T. Shenan, Esq. on behalf of Ronald V. Johnston.

## DECISION

### I. Procedural Background

#### A. Complaint

The Department of Enforcement (“Enforcement”) filed a seven cause Complaint in this proceeding on September 8, 1997. The Complaint charged W.B. McKee Securities, Inc. (“WBSI”), William B. McKee, Robert J. Trask, Gary J. Sherman, Ronald V. Johnston, and John M. Gersten with various violations of the securities laws and NASD rules. The gravamen of the Complaint relates to the manner in which WBSI conducted an initial public offering of the securities of Diehl Graphsoft, Inc. (“Diehl Graphsoft”) in late 1994. Enforcement, among other things, charged that WBSI: violated Exchange Act Rule 10b-9 in connection with a best efforts underwriting of Diehl Graphsoft’s securities; paid a selling concession to Inter-Cap, Ltd., an entity that is not a registered broker-dealer or NASD member, in connection with a private placement of securities of Integrated Security Systems, Inc. (“ISSI”) in violation of NASD Conduct Rule 2420; sold shares at a discounted price to several institutions in the Diehl Graphsoft fixed-price offering in violation of Conduct Rule 2740; and violated the net capital rule. Enforcement also charged WBSI and various individuals, including Respondent, with supervisory deficiencies.

All Respondents filed answers contesting the Complaint's allegations and, with the exception of Respondent Johnston, entered into Offers of Settlement. This decision relates exclusively to the charges in the Complaint relating to Respondent Johnston.<sup>1</sup>

The Department of Enforcement served Respondent Johnston with the Complaint in this proceeding on September 5, 1997. The Complaint's allegations involving Respondent Johnston are contained in Causes Five, Six and Seven.

1. Cause Five

Cause Five of the Complaint charged Johnston with failing to establish, maintain and enforce written procedures to supervise WBSI's business, and the activities of its registered and associated persons in a manner reasonably designed to achieve compliance with applicable laws, regulations and rules for deficiencies in nine areas of the firm's written supervisory procedures during the period January 1 - March 30, 1995 (the "relevant period"). In particular, Enforcement charged Respondent within the relevant period with responsibility for: (1) failing to maintain an accurate and current designation of supervisors and assignment of registered principals in the firm's written supervisory procedures; (2) failing to include provisions for the supervision of the manner in which cash receipts were handled in the firm's written supervisory procedures; (3) having conflicting provisions pertaining to discretionary accounts and the supervision of those accounts in the firm's written supervisory procedures; (4) failing to include provisions for the review and supervision of transactions to determine whether order tickets were marked long or short and stock location in the firm's written supervisory procedures; (5)

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<sup>1</sup> None of the Hearing Panel's findings and conclusions is binding as to Respondents WBSI, William B. McKee, Robert J. Trask, John M. Gersten, or Gary J. Sherman. Each of these Respondents elected to

failing to include provisions for the review or inspection of the firm's branch offices in the firm's written supervisory procedures; (6) failing to provide for the supervision of sales activities relating to penny stocks in the firm's written supervisory procedures provisions; (7) failing to include provisions in the firm's written supervisory procedures reasonably designed to ensure that transactions for or by associated persons conformed to the requirements of Conduct Rule 3050; (8) failing to address reports the Compliance Registered Options Principal ("CROP") is required to make to the firm's management; and (9) failing to include provisions in the firm's written supervisory procedures relating to uncovered short options transactions, including the requirement that a Special Statement for Uncovered Options Writers be disseminated.

2. Cause Six

In Cause Six of the Complaint, Enforcement alleged Respondent was responsible during the relevant period for failing to establish and maintain written procedures for a registered principal's review and written endorsement on an internal firm record of transactions effected by subscription agreements. Enforcement specifically alleged that WBSI failed to evidence the review of customer purchases by subscription agreement in the 1995 private offering of ISSI securities.

3. Cause Seven

Enforcement alleges that Respondent Johnston and others violated Conduct Rule 2110 by permitting six purchasers of Diehl Graphsoft, Inc.'s shares to be charged miscellaneous and other postage charges totaling \$5.00 per transaction that were not

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submit Offers of Settlement that the National Adjudicatory Council accepted; those offers set forth findings and conclusions applicable to each Respondent.

disclosed in the Diehl Graphsoft prospectus.<sup>2</sup>

B. The Hearing

The Hearing in this proceeding was held in Phoenix, Arizona on February 24-25, 1998 before a Hearing Panel composed of the Hearing Officer and two current members of the District 3 Committee. Enforcement and Respondent each presented two witnesses.

Enforcement called Christine Sarno, an examiner from the NASD's Denver District Office, and Lonnie Morgan, a supervisor of examinations in the NASD's Denver District Office. Ms. Sarno, the NASD examiner responsible for monitoring the financial condition of WBSI in 1994-95, participated in the NASD's 1994 and 1995 examinations of WBSI.<sup>3</sup> Ms. Morgan is a supervisor of examiners in the NASD Denver District Office, and Ms. Sarno's supervisor.<sup>4</sup>

The Hearing Officer admitted into evidence 23 exhibits Enforcement offered (CX 1, CX 3-24)<sup>5</sup> and 25 exhibits Respondent offered (RX 2-8, RX 10-13, RX 16-19, RX 23-25, and RX 28-34).<sup>6</sup>

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<sup>2</sup> The Parties jointly stipulated that: (1) six McKee customers who purchased Diehl Graphsoft were charged \$5.00 each for miscellaneous and postage expenses; and (2) the Diehl Graphsoft prospectus did not include a disclosure that purchasers would or might be charged any amount in excess of the published offering price in connection with a purchase of the securities sold pursuant to the prospectus. See Joint Stipulation dated February 2, 1998 and McKee Hearing Transcript at 14-15 (hereafter cited as Tr.).

<sup>3</sup> Tr. at 25-26 and CX 14.

<sup>4</sup> Tr. at 33.

<sup>5</sup> References to Enforcement's Exhibits admitted at the Hearing will be designated "CX". Enforcement did not offer into evidence its pre-marked exhibit CX 2. Enforcement also did not offer into evidence pages 7-9 of Enforcement's CX 4, pages 6, 7, 10, and 11 of CX 7, and pages 4-9 of CX 11.

<sup>6</sup> References to Respondent's Exhibits admitted at the Hearing will be designated as "RX". Respondent did not offer into evidence certain exhibits submitted in his pre-hearing submission because they were duplicative of certain Enforcement exhibits. In particular, Respondent did not offer Respondent's pre-marked exhibits RX-1, RX-9, RX-14, RX-15, RX-20, RX-21, RX-22, RX-26 and RX-27.

Respondent called Bruce Guenther and himself as witnesses.

## **II. Findings of Fact and Conclusions of Law**

### **A. Respondent's Background**

Respondent Johnston began working in the securities industry in 1968. (Tr. 229). He currently works at First Liberty Investment Group, a member firm located in San Diego, California, and is qualified as a general securities representative, a general securities principal, a municipal securities principal, a registered options principal, and a branch office supervisor. (Tr. 228-29 and CX 1). Respondent also is licensed to sell life and disability insurance in California. (Tr. 229).

Prior to becoming associated with First Liberty in September 1997, Respondent worked at several member firms,<sup>7</sup> including WBSI from May 1994 to April 1995. (Tr. 231-32 and CX 1).

### **B. Respondent's Association with WBSI**

Respondent testified that prior to joining WBSI he was acquainted with William McKee professionally and personally. (Tr. 232). In the months immediately before Respondent became associated with WBSI, William McKee and Respondent discussed the possibility of combining WBSI with Respondent's firm, Lam Wagner, Inc., with Mr. Johnston assuming the national sales manager position at the combined firm. (Tr. 232). The business combination did not occur, and Respondent testified that William McKee subsequently contacted him after Candy Wilson, WBSI's Compliance Officer, suddenly, and without notice, resigned late in the week of May 9, 1994. (Tr. 233).

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<sup>7</sup> National Securities Corporation (October 1996 - September 1997); First Allied Securities, Inc. (December 1995 - November 1996); H.J. Meyers & Co., Inc. (May 1995 - December 1995). CX 1.

Respondent agreed to join WBSI the following Monday, subject to certain conditions, and assumed a position as a managing director with responsibility for the firm's retail sales force.<sup>8</sup> (Tr. 233-34). Respondent's immediate responsibilities included general oversight of the firm's retail sales force in the Phoenix home office as well as the firm's branch offices in New York, Dallas, Tuscon and Sun City, recruitment of sales representatives, and the compliance duties Ms. Wilson performed, until a full-time compliance director could be hired. (Tr. 233-34).

In negotiating with Mr. McKee, Respondent indicated that he was not willing to relocate from San Diego to Phoenix, but would spend as much time as necessary in Phoenix or other branch offices to resolve whatever difficulties arose. (Tr. 234). Respondent arranged to stay with an acquaintance, Bruce Genther, when spending time in Phoenix at the firm's main office. Respondent testified that he spent most of his first three weeks with WBSI in the New York branch resolving serious problems that threatened the firm's solvency. (Tr. 235). Respondent then spent the next four weeks in the firm's Phoenix office assessing the firm's needs. (Tr. 235-36). Subsequently, Respondent settled into a more regularized schedule, spending 3-4 days per week in Phoenix, one day per week in San Diego, and two days a month in the Dallas branch office. (Tr. 236).

Respondent experienced significant health problems, beginning in September 1994, that restricted his ability to travel and perform his assigned duties for several months. (Tr. 241-43 and RX 34). Respondent specifically noted that he suffered from a severe angina attack on September 3 or 4, 1994, and that his doctor restricted him from flying or

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<sup>8</sup> Respondent began his association with WBSI on May 16, 1994.



otherwise traveling for approximately one month. (Tr. 242). Respondent informed Messrs. McKee, Sherman and Gersten what had transpired and that he would need their assistance for on-site review of compliance-related issues for a period of at least 30 days. (Tr. 243). Respondent remained in San Diego for the next 30-45 days, working when possible via his computer, fax and overnight delivery services.<sup>9</sup> Ultimately, after concluding that he could no longer handle all his assigned responsibilities, Respondent informed Messrs. McKee, Gersten and Sherman that he wanted to be relieved of his compliance responsibilities. (Tr. 246). Somewhere between February 15 and 19, 1995, Mr. Gersten assumed Respondent's compliance responsibilities. (Tr. 246). Respondent, however, continued to provide assistance during a transition period.

C. 1994 and 1995 Examinations of WBSI

NASD examiners conducted routine examinations of WBSI in 1994 and 1995. Ms. Sarno, who participated in both the 1994 and 1995 examinations, testified that NASD examiners identified deficiencies, including numerous deficiencies relating to the firm's written supervisory procedures, in the 1994 examination that resulted in a Compliance Conference in February 1995.<sup>10</sup> (Tr. 26 and CX 16). The 1994 examination field work concluded with an exit conference on June 30, 1994, at which NASD staff

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<sup>9</sup> Respondent testified: "So I tried to minimize the impact on the firm, but physically could not be present in any of the branches during approximately a month to a month and a half period of time." (Tr. 243).

<sup>10</sup> A staff ordered Compliance Conference is not considered formal disciplinary action; however, Compliance Conferences are not routinely held at the conclusion of an examination and are generally used to signal to a firm's senior management that certain issues need to be addressed promptly.

identified deficiencies with the firms' written supervisory procedures.<sup>11</sup>

WBSI began revising its written supervisory procedures. (Tr. 32 and CX 15). Respondent testified that he drafted 40-50 pages of new or revised procedures for inclusion in WBSI's policies and procedures manual and forwarded them to NASD staff in Denver for comment. (Tr. 328-29, 416-17). NASD Regulation staff subsequently reviewed the firm's revised written supervisory procedures and, in a November 1, 1994 letter to Respondent,<sup>12</sup> indicated that the firm's revised policies still failed to sufficiently address the firm's business. ( Tr. 36-38 and CX-14 at 1).<sup>13</sup> The November 1 letter noted specific deficiencies, including outdated principal designations, unclear branch office supervisory procedures, lack of reference to the SEC's penny stock rules, and lack of reference to uncovered options writing. (CX 14 at 2-3).

NASD Regulation staff further advised WBSI in a January 23, 1995 letter that a Compliance Conference was scheduled for February 16, 1995 in the NASD Regulation

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<sup>11</sup> Respondent participated in the exit conference via telephone from San Diego. (Tr. 29). NASD staff specifically noted at the exit conference that the firm's written supervisory procedures needed to be updated to show current designation of supervisors and assignment of registered representatives to general securities principals, contained no procedures for the review of cash receipts, contained conflicting provisions regarding discretionary accounts, did not discuss how the firm would review and supervise its procedures for marking order tickets long or short and affirmatively determining stock location, and do not address uncovered short option transactions and the dissemination of the special uncovered statement for uncovered options writers. (CX 15 at 5-6).

<sup>12</sup> Ms. Sarno testified, however, that the date stamp on page 1 of CX 12 indicated that NASD Regulation received WBSI's 1994 policy and procedures manual (CX 12) on August 26, 1994, and that, to the best of her recollection, the complete exhibit was received at that time. Ms. Sarno did not recall receiving any supplemental addenda between August 26, 1994 and the Compliance Conference on February 16, 1995. (Tr. 152).

<sup>13</sup> The specific purpose of this November 1, 1994 letter from Lonnie Morgan (CX 14) to Respondent was to address WBSI's proposed restriction agreement modification. The firm was seeking to establish a branch office in San Diego, designate the Dallas branch office as an Office of Supervisory Jurisdiction, and increase the number of registered representatives to 80. NASD Regulation staff denied the requested modifications.

Denver District Office to discuss in detail the findings from the 1994 routine examination. (CX 16). The January 23, 1995 letter identified deficiencies in the firm's policy and procedures manual, specifically identifying 21 areas that needed to be addressed. (CX 16 at 3-7).

NASD Regulation staff met with William McKee, John Gersten, and Respondent at the Compliance Conference with WBSI on February 16, 1995. (CX 17).<sup>14</sup>

D. Respondent's Responsibilities at WBSI

The Department of Enforcement and Respondent differ with regard to Respondent's actual responsibilities during the January 1 - March 31, 1995, period and whether Respondent was responsible for the deficiencies in the firm's supervisory procedures, if any, charged in Cause Five of the Complaint.

Respondent acknowledges that WBSI designated the Compliance Officer as the person in the firm with responsibility for the firm's written supervisory procedures and that he assumed responsibility for those procedures by filling the Compliance Officer's position on an interim basis. (Tr. 233 and 311).

There is no dispute that Respondent began his association with WBSI on May 16, 1994, after the unexpected resignation of WBSI's Compliance Officer. Respondent assumed the position of Compliance Officer until a permanent replacement could be found. Upon joining WBSI, however, Respondent found the firm to be experiencing significant difficulties in several of its branch offices (Tr. 235), most notably in New

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<sup>14</sup> Respondent testified that Gary Sherman also was present at the Compliance Conference, and that the NASD Regulation staff's memorandum (CX 17) did not record Mr. Sherman as being present. (Tr. 312, 343).

York,<sup>15</sup> and the firm's financial condition was precarious, significantly worse than what Mr. McKee had represented during their negotiations.

After suffering an angina attack in early September, 1994, Respondent de facto ceded certain on-site compliance responsibilities to Messrs. Sherman and Gersten while he was undergoing medical treatment in San Diego and subject to travel restrictions. (Tr. 238-40).<sup>16</sup>

Respondent testified that prior to the Compliance Conference he formally ceded his compliance responsibilities to Mr. Gersten. (Tr. 246). Respondent stated that he informed Messrs. McKee, Sherman and Gersten in February 1995 that he could no longer serve as the firm's Compliance Officer, and that Mr. Gersten had agreed to assume those responsibilities.<sup>17</sup> Although Respondent still planned to attend the upcoming Compliance Conference, his expectation was that Mr. Gersten would be principally responsible for discussing supervisory related issues with NASD Regulation staff. (Tr. 247-48).

Respondent further claimed that Mr. McKee notified Ms. Morgan that Mr. Gersten was assuming compliance responsibility from Mr. Johnston and would be attending the Compliance Conference. (Tr. 247, 313). Neither Ms. Sarno nor Ms. Morgan could recall being notified that Mr. Gersten had assumed Respondent's

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<sup>15</sup> Respondent stated: ... "it was immediately evident to me that they had in New York an office that was totally out of control that would bring the firm down if something wasn't done immediately about it, ..." (Tr. 235). "I spent a large part of that time in New York unraveling that office, trying to audit what they had been doing to determine the firm's exposure, terminating all of the personnel in that office, trying to find a sublease tenant for that office, and, as an end result, closing that office." (Tr. 235).

<sup>16</sup> RX 34 at 300130-136 establishes that Respondent underwent medical care and tests on September 3 and September 9, 1994, and corroborates Respondent's testimony.

<sup>17</sup> Respondent noted that his salary was reduced and Mr. Gersten's salary was increased correspondingly to reflect the reallocation of WBSI's compliance responsibilities from Respondent to Mr. Gersten. (Tr. 321).

compliance responsibilities prior to or during February 16, 1995 Compliance Conference (Tr. 51, 110).

The Hearing Panel finds that the documentary evidence as to when Mr. Gersten assumed compliance responsibilities is ambiguous. On the one hand, a September 6, 1996 letter from Julie Gebert, then the Senior Vice President for Compliance and Operations at WBSI, to Ms. Sarno included a March 30, 1995 designation by William McKee, and September 14, 1995 and January 22, 1996 designations by Gary Sherman each indicating that John Gersten assumed the duties of Compliance Officer for WBSI on February 15, 1995 (CX 7 at 5-8). On the other hand, a February 22, 1995 designation by William McKee indicates WBSI's Compliance Officer as: Ron Johnston, John Gersten, on site, and Gary Sherman. (CX 4 at 2).<sup>18</sup> Mr. Gersten also indicates in a December 19, 1996 letter to Ms. Morgan that Mr. McKee requested that he take over the responsibilities of compliance officer in March 1995. (Tr. 112 and CX 11 at 10).<sup>19</sup>

The Hearing Panel found Respondent's testimony that he ceded his compliance responsibilities to Mr. Gersten before the February 16, 1995 Compliance Conference to be unambiguous and credible, as it was corroborated by WBSI documents prepared before individuals were informed that they might be involved in a formal disciplinary

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<sup>18</sup> The Hearing Panel notes that although CX 4 could be interpreted to mean that Respondent was the compliance officer as of February 22, 1995 and Messrs. Gersten and Sherman were alternates; the exhibit also could be interpreted to be consistent with Respondent's statements that he had agreed to continue to assist Mr. Gersten with compliance duties during a transition period.

<sup>19</sup> Enforcement moved for the admission of only certain pages of CX 11. Pages 10-11 of the exhibit were not offered or admitted; however, the Hearing Officer has admitted pages 10-11 of CX 11 into evidence because those pages came into the record without objection via Ms. Whelan's examination of Ms. Morgan. (Tr. 111).

action,<sup>20</sup> and was not directly contradicted by either Ms. Sarno or Ms. Morgan.<sup>21</sup> The Hearing Panel therefore finds that, based on the evidence presented, Respondent ceded his compliance responsibilities to Mr. Gersten as of February 15, 1995.

In addition, the Hearing Panel notes that the policy and procedures manual in effect for the period January 1- March 31, 1995 is not in evidence. Enforcement offered into evidence a 1995 policy and procedures manual that NASD Regulation staff obtained from WBSI during the late fall of 1995 in connection with the 1995 WBSI examination (CX 13, RX 3, and Tr. 57, ), and a 1994 WBSI policy and procedures manual NASD Regulation staff obtained from WBSI in August 1994. ( CX 12 and Tr. 32). Although Respondent repeatedly noted that CX 13 and RX 3 were not the policy and procedures manual in effect during the January-March 1995 period (Tr. 255-56, 331), Respondent was unable to recall how the 1995 policy and procedures manual in evidence materially differed from the policy and procedures manual in effect while he was still at WBSI in the first quarter of 1995. (Tr. 332-34).

E. Cause Five

Enforcement specifically alleges that Respondent violated Conduct Rule 3010 during the three month period between January 1, 1995 and March 31, 1995 because he was responsible for maintaining the firm's written supervisory procedures, which Enforcement determined were deficient in nine specific areas: current designation of

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<sup>20</sup> In response to questions by one of the Hearing Panelists, Ms. Morgan indicated that Mr. Gersten was aware of the fact that he might be named as a respondent at the time Mr. Gersten responded to Ms. Morgan in a December 19, 1996 letter noting that Mr. Gersten had taken over the responsibilities of compliance officer in March 1995. (Tr. 216-18).

<sup>21</sup> Both Ms. Sarno and Morgan testified only that they could not recall being informed before or during the Compliance Conference that Mr. Gersten had replaced Respondent as WBSI's Compliance Officer. (Tr. 51, 110).

supervisors and registered principals; handling of cash receipts; discretionary accounts; marking order tickets long or short and determining stock location; review or inspection of branch office activities; transactions in penny stocks; transactions by or for associated persons; CROP reports to firm management; and uncovered options writing.

Conduct Rule 3010 requires member firms to establish a supervisory system reasonably designed to achieve compliance with applicable laws, rules and regulations. The Rule further requires that, as a component of the supervisory system, a member establish and maintain written supervisory procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable laws, rules and regulation.

The Hearing Panel concluded that WBSI's business was such that it needed to have supervisory procedures that addressed each of the nine items identified in the Complaint. WBSI's written supervisory procedures for each of these nine areas are discussed below.

1. Current Designation of Supervisors and Assignment of Registered Principals

Enforcement's exhibits indicate that the firm's designation of supervisors and the assignment of registered principals during the January 1- March 31, 1995 period were inaccurate and not current. (Tr. 89-93, CX 3, and CX 4).<sup>22</sup> In particular, Ms. Sarno

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<sup>22</sup> CX 3 is a chart prepared by Ms. Sarno comparing WBSI's Compliance Officer designations obtained from firm records during examinations in 1994 and 1995 with documents sent to the staff as exhibits to a September 6, 1996 letter from Julie Gebert, then WBSI's Compliance Officer. CX 4 consists of a September 1, 1994 Designation of Registered Principals; a February 22, 1995 Designation of Supervisory Duties For WBSI; a March 24, 1995 Designation of Supervisory Duties For WBSI; and a September 14, 1995 Designation of Supervisory Duties For WBSI.

testified that the firm's designation for its Compliance Officer dated February 22, 1995 indicates that Respondent was WBSI's Compliance Officer while a designation dated March 30, 1995 indicates that John Gersten was the firm's compliance officer as of February 15, 1995. (Tr. 88-91). The Hearing Panel finds that Respondent, at least during the January 1 - February 15, 1995 period, was responsible for assuring that WBSI's designations of supervisors and principals were current and in conformance with Conduct Rule 3010, including an identifiable date as to when the designated person assumed his or her responsibility.<sup>23</sup>

The Respondent claimed at Hearing that some of the designations of supervisors and principals forms that NASD staff obtained from WBSI were unfamiliar to him, appeared inaccurate, and were of a type and font that differed from the printer he used while at WBSI. (Tr. 331-332).<sup>24</sup> Respondent, however, acknowledged that he had prepared the June 21, 1994 (CX 5), September 1, 1994 (RX 13 at 30053-58), and December 14, 1994 (RX 29 at 300107-08) designations. (Tr. 334-39). The Hearing Panel finds the December 14, 1994 designation of particular significance because it immediately predates the January 1, 1995 - March 31, 1995 period Enforcement references in the Complaint. Respondent also acknowledged that the December 14, 1994

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<sup>23</sup> Conduct Rule 3010(b)(2) provides, in pertinent part: "The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective."

<sup>24</sup> Respondent testified that he created approximately 40 pages of new and revised material for WBSI's policy and procedures manual in response to NASD staff-identified deficiencies. The WBSI policies and procedures manual that the NASD staff received from WBSI, according to Respondent, differed from the policy and procedures manual that was in effect when he left the firm in 1995. (Tr. 331-32) Respondent testified that "I do know in both editions, your 12 and your 13, Ms. Whelan, there are documents such as a designation of supervisory duties for W. B. McKee Securities that are erroneous, that are typed on a different machine, that are printed with a laser printer, that were not mine, and they were all prepared after I had departed the firm to cover people's tushes, and things were changed." (Tr. 331-32).



Designation of Supervisory Duties (RX 29) was in WBSI's policy and procedures manual when he left the firm in April, 1995. (Tr. 334). Yet the December 14, 1994 designation is deficient because it provides no dates for which the identified persons assumed their responsibilities as required by Conduct Rule 3010(b)(2).

Respondent further acknowledged that he learned at the June 1994 exit conference that NASD Regulation staff considered WBSI's written supervisory procedures deficient because they did not contain an accurate, complete and current designation of the firm's principals and supervisors. (Tr. 341). In light of this identified deficiency, Respondent indicated that he would have prepared a document "that listed those responsibilities and pretty well demarked what the responsibilities and duties of those personnel were to be, what their tenure was and what their responsibilities were." (Tr. 342). When specifically asked about the absence of dates upon which the identified supervisors and principals assumed their duties, Respondent stated: "Just because it's continuing doesn't mean that you don't denote it as of that date. At least that was my interpretation, if that would be effective." (Tr. 336-37).

The Hearing Panel concludes that Respondent was aware that NASD Regulation staff determined that WBSI's supervisory and principal designations were deficient in 1994 and that the actions Respondent took to address those deficiencies, as manifested in the December 14, 1994 designation, were inadequate.

## 2. Supervision of Cash Receipts

The Respondent expressly acknowledged that he prepared the section of the firm's policy and procedures manual relating to currency and cash. (Tr. 265-66). WBSI's

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policy was to prohibit registered representatives or associated persons from accepting cash or currency from clients. (RX 3 at 300561; RX 12 at 300852).<sup>25</sup> In addition, WBSI restricted registered representatives and associated persons from accepting checks made payable to WBSI; receipt of such checks would change the firm's minimum net capital requirements. Yet during cross examination, Respondent admitted that on occasion WBSI would receive checks made payable to WBSI, and rather than returning the check to the customer requesting that it be made payable to the clearing firm, WBSI employees would retain the check and deposit it into the clearing firm's bank account. (Tr. 346-47).

In response to a direct question concerning what procedures the firm had developed to monitor for the receipt of checks payable to WBSI, Respondent explained the policy prohibiting the action, but offered no information relating to a system designed to check to see whether the firm's policies were being followed. (Tr. 348-49).<sup>26</sup> Respondent also acknowledged that NASD staff identified the firm's written supervisory policies in this area as deficient at the June 1994 exit conference in which Respondent participated by telephone. (Tr. 348, Tr. 49-50).

The NAC and SEC provide guidance as to what is required for written supervisory guidelines to comply with NASD Conduct Rule 3010(b). In In the Matter of the

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<sup>25</sup> "It will be the policy of [WBSI] to not accept currency from our clients. Should any Associated Person or Registered Representative take receipt of currency, he will be instructed to immediately return currency to the client and request that said client prepare a check, cashiers check or money order payable to the issuer or W.B. McKee Securities, Inc.'s clearing firm. Under no circumstances is the Associated Person or Registered Representative to accept currency into his personal funds and prepare a check, cashiers check or money order to the issuer or clearing firm in the name of said client." (RX 3 at 300561).

<sup>26</sup> Respondent noted "[if] they didn't tell me that they had, then I didn't know that they hadn't done their job. I presume that people do their job. If someone works hard enough, they can always hide their actions. [I]f checks like this went through, I guess she wasn't telling me everything that went on." (Tr. 350).

Application of Gary E. Bryant, Exchange Act Release No. 32357 (May 24, 1993), 51 S.E.C. 463, 1994 SEC LEXIS 1347 at \*19, the SEC affirmed an NASD disciplinary proceeding and found Respondent's written supervisory guidelines deficient since there were no mechanisms for ensuring compliance and did not establish specific functions to be followed by the person identified as responsible for ensuring compliance by the firm and its registered representative. Id.<sup>27</sup>

As the SEC noted in Bryant, "to ensure investor protection, a broker-dealer must establish and enforce effective procedures to supervise employees (citation omitted). The procedures must assure that restrictions issued are not ignored by branch managers, registered representatives or any other office personnel."<sup>28</sup> Respondent noted that after the June 1994 exit conference, WBSI's policy was clarified. "Marlys Corcoran, as the principal in charge of operations, was to review the blotter each day of all incoming checks and should have stopped it before the day was over and sent the checks back to the people along with a letter." (Tr. 348-49). The Hearing Panel concluded that the firm's written supervisory procedures were deficient because they provided no procedures or guidance to monitor for compliance with WBSI's policy prohibiting acceptance of

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<sup>27</sup> In Bryant, the Respondent firm's written supervisory procedures consisted of "two pages of specific procedures with a one-page addendum enumerating 18 'prohibited business practices'." Market Surveillance Committee v. Anderson, Bryant & Co., Complainant No. MS-803 at 18 (August 1, 1991). In sustaining the Association's decision, the SEC found that the Respondent firm's written supervisory procedures provided "nothing more than a list of things that the firm and its representatives should not do." 1994 SEC LEXIS 1346 at 19. The SEC also found that "the firm's structure included no specific controls or supervisory procedures designed to deter and detect misconduct." Id. See also Market Regulation Committee v. Castle Securities Corp., Complaint No. CMS 940100, 1996 NASD Discip. LEXIS 37, at \*24-6 (NBCC October 21, 1996), aff'd, In re Castle Securities Corp., Exchange Act Release No. 39523, 66 S.E.C. Docket 531, 1998, SEC LEXIS 24 (Jan. 7, 1998); In re Freeland, Exchange Act Release No. 32192, 53 S.E.C. Docket 2452, 1993 SEC LEXIS 878 at \*6 (April 22, 1993).

<sup>28</sup> Bryant, supra, 1994 SEC LEXIS at \*19.

checks made payable to WBSI. Respondent is responsible for this deficiency for the period January 1 - February 15, 1995.

### 3. Discretionary Accounts

Enforcement alleges that WBSI's policy and procedures manual was deficient with regard to discretionary accounts because it was internally inconsistent, permitting discretionary accounts, subject to certain conditions, on the one hand and then prohibiting any discretionary accounts on the other hand.

The firm's written supervisory procedures provide that ... "opening Discretionary Accounts is not encouraged by the administration of [WBSI.] The legal and ethical ramifications are of such a serious nature that we are very hesitant to grant permission for such accounts. However, if valid reasons exist for a Discretionary Account, it will be considered." (RX 3 at 300540). If a discretionary account were accepted, "[s]pecific, written approval of both the Chief Compliance Officer and the President of W.B. McKee Securities, Inc. [would be] required." (RX 3 at 300539 and Tr. 268). In addition, each discretionary order needed to be designated discretionary and approved in writing by the Chief Compliance Officer prior to being entered. (RX 3 at 300540 and Tr. 268).

In another section of the firm's written supervisory procedures entitled "Prohibited Business Practices," exercising discretion (other than time and price) with respect to any customer's account without prior written approval is identified as a prohibited practice (RX 3 at 300508), as is accepting or exercising any discretionary power without the prior written approval of the Chief Compliance Officer. (RX 3 at 300510). In another section of the firm's policy and procedures manual designated "Supervision," however, the

following language appears: “Discretionary Accounts: No discretionary accounts will be accepted.” (RX 3 at 300472).

Respondent testified that he did not believe that the “no discretionary accounts will be accepted” language was inconsistent with other provisions in the policy and procedures manual referring to discretionary accounts. (Tr. 272). The prohibition on discretionary accounts referenced above, according to Respondent, related to situations involving a registered representative being given authority to trade a client’s account. (Tr. 273). Accounts in which a money manager or other qualified third person was given authority to make trading decisions, however, are different. (Tr. 273). In those instances, WBSI would accept the account. (Tr. 273). Respondent unequivocally stated ... “that discretionary accounts where the broker had authority to act with discretion were not acceptable.” (Tr. 273).

The Hearing Panel finds that although the firm’s policy and procedures manual may technically be inconsistent inasmuch as one section provides that no discretionary accounts shall be accepted and other sections discourage the acceptance of discretionary accounts unless written approval of the Chief Compliance Officer and President are obtained, Respondent provided an explanation that is not implausible. Consequently, the Hearing Panel is unable to conclude, on this record, that WBSI’s written supervisory procedures with respect to discretionary accounts were deficient.

#### 4. Marking Order Tickets Long or Short and Determining Stock Location

Enforcement alleges that WBSI’s policy and procedures manual is deficient with regard to marking order tickets long and short and determining the location of stock

because of the absence of procedures that are designed to ensure that WBSI's order ticket procedures are being followed.

WBSI's 1994 and 1995 policies and procedures manuals both clearly indicate that all order tickets need to be marked long or short (CX 12 at 105 and RX 3 at 300581), and an affirmative determination made as to the location of the security being sold. (CX 102 and RX 3 at 300579-80; Tr. 274-76). In addition, the policies and procedures manuals provide that all order tickets must be approved by the chief trader and branch manager. (CX 12 at 107, RX 3 at 300461 and Tr. 278-79).

The Hearing Panel finds that the firm's written supervisory policies with respect to marking order tickets long or short and determining stock location were not insufficient. The firm's written policy and procedures manual specifically provides that all offices and or branch locations are to be audited by the Compliance Department to insure that daily office procedures, which would include branch manager review of order tickets, are being followed. (RX 3 at 300452). Consequently, the Panel concludes that WBSI's written supervisory procedures established procedures that provided for the review designed to verify that persons required to perform various functions in the branch offices in fact were performing those functions.<sup>29</sup>

##### 5. Review or Inspection of WBSI Branch Offices

Enforcement claims that the firm's written supervisory procedures are deficient because there is no provision for the review or inspection of activities in the firm's branch

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<sup>29</sup> The mere fact that NASD Regulation examiners found order tickets that were not marked long or short does not mean that the firms' written supervisory procedures were deficient. The question is whether the firm's policies and procedures were ... "reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association." Conduct Rule 3010(a).

offices. The 1994 and 1995 firm policy and procedures manuals provide guidance for branch managers with respect to what they must do to satisfy their supervisory obligations. (CX 12 at 127-129 and RX 3 at 300447-452). Among other things, those manuals note that branch managers, on a daily basis, need to review transactions and initial order tickets, review and initial the daily trade and commission blotters, and review and approve all correspondence. (CX 12 at 128-29; RX 3 at 300451 and 300461; Tr. 62). The manuals also provide that “[a]ll offices and or branch locations are to be audited by the Compliance Director to insure that daily office procedures are being followed and that required files are being accurately maintained.” (CX 12 at 129; RX 3 at 300452). However, the firm’s policy and procedures never established a branch inspection or audit schedule.<sup>30</sup>

Ms. Sarno testified that she would have expected to see procedures that identified what would be included within the scope of a branch audit, a checklist of items that would be reviewed when the annual inspection was done, some report or at least some reference to a report that would be prepared based on a compliance audit of the branch. (Tr. 75). She also noted that WBSI’s policy and procedure manuals did not contain any provisions that would allow an auditor to monitor the performance by a branch manager of the duties

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<sup>30</sup> See CX 12 at 233. This page of the 1994 Policy and Procedure Manual is entitled “Review of Offices.” It references the requirement that Offices of Supervisory Jurisdiction be inspected annually and other branch offices inspected according to the firm’s policy, and notes that a written record of each review is required to be maintained; however, the document is blank. In addition, even though a footnote indicates that such information can be maintained on another internal firm record rather than in the manual, the firm failed to produce any such other record.

imposed upon him by the firm's procedures (Tr. 76).<sup>31</sup>

The Hearing Panel concludes that WBSI's 1995 written supervisory procedures relating to branch office inspections were deficient because they failed to establish procedures that provide reasonable detail as to how WBSI would review and monitor its branch office activities, and insure that branch managers and others were complying with their assigned responsibilities. Simply providing that Compliance will conduct an annual inspection of branch offices is not adequate.<sup>32</sup> The NAC repeatedly has stated that policies and procedures that only describe or restate the regulatory requirements are not sufficient. See, e.g., District Business Conduct Committee For District No. 10 v. Stratton Oakmont, Inc., Complaint No. C10950081, 1996 NASD Discip LEXIS 52 (NBCC December 5, 1996).

#### 6. Transactions in Penny Stocks

In WBSI's 1994 and 1995 policy and procedures manuals, the firm notes that recommended transactions in low priced securities, although generally not an activity the firm desires to be actively involved with, are not prohibited. (CX 12 at 184-189 and CX 13 at 48-53). The 1994 policies, however, reference only Exchange Act Rule 15c2-6 and ignore the penny stock rules (15g-1 through 15g-9), which came into effect in April 1992.<sup>33</sup>

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<sup>31</sup> E.g., procedures to ascertain whether a branch manager was making appropriate judgments with respect to suitability determinations, monthly account statement reviews, or daily order ticket reviews.

<sup>32</sup> See Bryant, supra. "The procedures must assure that restrictions issued are not ignored by branch managers, registered representatives or other office personnel." Bryant, 1994 SEC LEXIS 1347 at \*19 .

<sup>33</sup> 57 FR 1802 ( April 28, 1992). Rule 15c2-6, which was adopted in 1989 with a January 1, 1990 effective date, involved low priced equity securities defined as "designated securities." 54 FR 35481 (August 28, 1989). Rule 15c2-6 was rescinded in 1993 and incorporated into Rule 15g-9. 58 FR 37417 (July 12, 1993).



In response to questions concerning whether he reviewed the firm's policies to determine whether they were sufficient in view of the adoption of the penny stock rules, Respondent stated "[m]y recollection is that as the rules changed, we did change the firm's penny stock rules to be in compliance with that. ..." (Tr. 388). Yet Respondent's testimony made clear that he was unaware that the penny stock rules imposed more and different obligations upon broker-dealers that recommended transactions in penny stocks.<sup>34</sup> (Tr. 388-89). In addition, Ms. Morgan's November 1, 1994 letter to Respondent specifically noted: "There were a couple of areas that were not addressed at all. Specifically, compliance with SEC 15g rules that deal with transactions in penny stocks. Please note these rules are in addition to the "cold call" rule formerly known as SEC Rule 15c2-6. The firm needs to either address the rules or indicate it will claim an exemption, and how it will document the availability of such exemption." (CX 14 at 2 and Tr. 389).<sup>35</sup> Although WBSI did not actively trade in penny stocks (Tr. 181-82), the Hearing Panel concluded that the firm's written supervisory procedures were inadequate in that they failed to address the penny stock rules and clarify that the firm needed to be able to demonstrate affirmatively any volume based exemptions it might claim.

#### 7. Transactions By or For Associated Persons

The Complaint alleges that the firm's written supervisory procedures did not

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<sup>34</sup> For example, Rule 15g-2 requires that a risk disclosure document concerning the penny stock market be provided to all customers before effecting any transaction in a penny stock. In addition, before effecting a transaction in a penny stock the broker-dealer must disclose to the customer the current bid and offer price for the security (Rule 15g-3) and the amount of compensation that the broker-dealer (Rule 15g-4) and individual sales representative (Rule 15g-5) will receive from the transaction.

<sup>35</sup> Respondent testified that he did not recall seeing Ms. Morgan's November 1, 1994 letter, noting that this occurred at a time when he "was under pretty heavy medical care." (Tr. 389)

include provisions reasonably designed to comply with Conduct Rule 3050. Rule 3050 involves transactions in securities for or by persons associated with member firm broker-dealers. Conduct Rule 3050(c) requires a person associated with a member firm, prior to opening an account or placing an initial order for the purchase or sale of securities with another member firm, to notify his or her employing broker-dealer and the executing broker-dealer in writing of his or her association.

Respondent testified that he believed that the provisions contained in the firm's policies and procedures manual (RX 3 at 300539) adequately provide for the supervision of and compliance with Conduct Rule 3050. (Tr. 287). In particular, Respondent identified provisions of the manual referencing employees of other firms that maintained accounts at WBSI (RX 3 at 300539 ¶M) and employees of WBSI who maintained accounts at the firm (RX 3 at 300539 ¶N).<sup>36</sup>

Enforcement claims that WBSI's written supervisory provisions are deficient because they fail to provide for how the firm will supervise its associated persons from effecting private securities transactions away from WBSI. Respondent acknowledged during cross examination that the provisions he referenced did not relate to the activities of the firm's registered representatives at other broker-dealers. (Tr. 392). Rather, Respondent indicated that there is an employment agreement signed by all registered representatives that prohibits maintenance of an account at another firm without prior written authorization. (Tr. 393). Further, questionnaires that were provided to all

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<sup>36</sup> With respect to employees of other securities firms, the procedures noted: (1) that a new account form is required; (2) specific written approval of the Compliance Officer is needed before an order can be entered; (3) written permission of the employer is needed; (4) duplicate confirmations of all trades will be forwarded to the employer broker-dealer; and (5) the account is subject to the Free-riding and Withholding rules of the NASD.

registered representatives each year specifically inquired whether they maintained any such accounts. In addition, the firm's policy and procedures manual provides "[s]hould a Registered Representative or Associated Person have an existing account with another broker-dealer, it is necessary to obtain prior written approval from the designated principal before any transaction can be made. [WBSI] may also require duplicates of all confirmations and statements should such account transaction be approved." (RX 3 at 300544).<sup>37</sup>

The Hearing Panel finds that the firm's policy and procedure for supervising employee accounts at other broker-dealers are not unreasonable. In particular, the policy clearly indicates that employees should maintain their accounts at WBSI. Special permission in writing is required if an employee seeks to open an account elsewhere and copies of duplicate confirmations are required. Moreover, the firm distributes an annual questionnaire to all registered representatives which, among other things, specifically requests information about any outside accounts they or their families maintain. In short, the Hearing Panel does not agree with Enforcement's contention that the firm's policy and procedures manual fails to address how the firm intends to review and supervise employees who maintain securities accounts at other broker-dealers.

#### 8. CROP Reports to Management

Enforcement alleges that the firm's 1995 written supervisory procedures were deficient because they did not address the reports required to be made to management by

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<sup>37</sup> The firm's policy and procedures manuals also indicate under a section entitled "Prohibited Practices" that maintaining an account with another broker-dealer is prohibited without prior written authorization of the firm and that if any transaction is effected in such an account, a duplicate confirmation must be sent to the firm. (RX 3 at 300512, CX 12 at 71, and Tr. 122-23).

the Compliance Registered Options Principal (CROP). Conduct Rule 2860(b)(2)(B) specifically provides that the CROP shall regularly furnish reports to the Compliance Officer (if the CROP is not himself the Compliance Officer) and to other senior management of the firm. There is no additional specificity provided in this rule as to what types of reports are contemplated.

Respondent admitted to preparing a December 14, 1994 designation of supervisory duties form in which he is identified as the Senior Registered Options Principal (SROP) and CROP. (RX 29 at 300108 and Tr. 334, 339). Respondent is also identified as the firm's CROP in a section of the firm's 1995 policy and procedures manual entitled "Options." (RX 3 at 300650-652).<sup>38</sup> Respondent, although testifying that he did not prepare the document from the firm's 1995 manual and did not recall that policy statement being in effect while he was at the firm, also testified that the issues covered in that document generally seemed consistent with what he recalled was in the firm's policy and procedures manual when he was there. (Tr. 288). Respondent added, however, that "... my recollection was we had a prohibition against naked writers without specific compliance and CROP approval prior to the writing of uncovered options, and I don't see that proviso or prohibition in this." (Tr. 288). Respondent also emphasized that he was unaware of any special report that the CROP was required to present to firm management (Tr. 290),<sup>39</sup> that "if I were to write a report, I'd be writing it

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<sup>38</sup> The firm's 1994 policy and procedures manual also contains a section entitled "Option Procedures and Policies." (CX 12 at 241-243).

<sup>39</sup> On cross examination, Respondent acknowledged that the absence of CROP reports for firm management review was raised by NASD Regulation staff in connection with the June 1994 exit conference. (Tr. 397). He also acknowledged that he never inquired of the NASD Regulation staff what reports they were referring to (Tr. 397), and that he had no recollection of inserting any procedures

to myself...” (Tr. 290), and that “any report, if we had any naked option writers that would come out that would be substantive and could red flag something, would be a report that our clearing firm, Hanifen Imhoff, would furnish to us showing uncovered positions in their daily report.” (Tr. 290). Respondent further added that WBSI received clearing firm reports daily and that those reports went to the firm’s Chief Financial Officer and others within the firm as well. (Tr. 290).

The Hearing Panel finds that Respondent, as the firm’s CROP, was responsible for providing periodic reports to management with respect to the firm’s options business. Because WBSI effected options transactions for customers, the firm’s written supervisory procedures were deficient in failing to address the fact that regular reports should be made to the firm’s management regarding the firm’s options activities. That the firm’s options business might have been minimal does not relieve the CROP of his responsibility to keep management informed. Whether the CROP could rely on the firm’s clearing reports to satisfy this responsibility would depend on the particular circumstances and the Hearing Panel need not make any findings regarding this matter. In addition, the Respondent acknowledges that he could not recall inserting any CROP management report procedures in the firm’s policy and procedures manual after the June 1994 examination exit conference when NASD Regulation staff informed him and others at the firm of this deficiency.

9. Short Option Transactions and Dissemination of Special Statement for Uncovered Option Writers

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concerning CROP reports to management in the firm’s supervisory procedures as a result of the staff’s position taken in connection with the 1994 examination. (Tr. 398).

Enforcement charges that the firm's written supervisory procedures were deficient because they failed to include provisions for uncovered short option transactions, including the dissemination of a Special Statement for Uncovered Option Writers.

NASD Conduct Rule 2860(b)(16)(E) specifically provides that each member transacting business with the public in writing uncovered short option contracts shall develop, implement and maintain specific written procedures governing the conduct of such business. Those written procedures, among other things, must provide "requirements that customers approved for writing uncovered short options transactions be provided with a special written statement for uncovered option writers approved by the Association that describes the risks inherent in writing uncovered short option transactions, at or prior to the initial writing of an uncovered short option transaction." Conduct Rule 2860(b)(16)(E)(v).<sup>40</sup>

Respondent testified that he did not recall any customers writing uncovered options while he was WBSI's CROP. (Tr. 291). Nevertheless, he also testified that WBSI had no policy prohibiting customers from writing uncovered options. (Tr. 291). Specific approval, however, would be required, and a customer would need "at least \$10,000 in excess equity in [the] account in order to maintain short or naked positions." (Tr. 291).

Respondent testified that he was aware of a special statement for uncovered option writers and characterized it as "an addendum piece with the Options Clearing

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<sup>40</sup> Other requirements for writing uncovered options include: developing specific criteria and standards to be used in evaluating the suitability of a person to write uncovered short options; developing specific procedures for approval of accounts engaged in uncovered short options transactions; designating the SROP and/or CROP as the person responsible for approving customer accounts that do not meet the specific firm standards for writing uncovered short options; and establishing minimum net equity requirements for initial approval and maintenance of accounts writing uncovered short option transactions. Conduct Rule 2860(b)(16)(E).

Corporation prospectus that denotes the risks of losing more money than you put up if you write naked or uncovered options. And most clearing firms supplied them in quantity to their clearing members from the OCC, which is the Options Clearing Corporation.” (Tr. 292-93). He further noted that he was sure they had a large quantity of them because he had reordered them since he joined WBSI. (Tr. 293).<sup>41</sup>

Although WBSI’s 1995 policy and procedures manual addresses certain of the required provisions of Conduct Rule 2860 relating to uncovered short option contracts, such as establishing minimum equity requirements for uncovered options writing (RX 3 at 300651), those policy and procedures are silent as to any special disclosure document that must be provided to customers approved for uncovered short options transactions at or prior to the initial writing of an uncovered short option transaction. WBSI’s policy and procedures also failed to establish specific suitability criteria for approving customers for uncovered short option transactions. The Hearing Panel therefore concludes that the firm’s written supervisory procedures were deficient.

F. Cause Six: ISSI Private Placement/Bridge Financing

Conduct Rule 3010(d) requires a member firm to establish procedures for the review and endorsement by a registered principal in writing, on an internal record, all transactions of the firm. The Complaint alleges that WBSI did not have procedures for the review and endorsement of subscription-way transactions, and that a principal did not review and endorse the ISSI private placement transactions. The Hearing Panel determined that a firm that participates in transactions that are evidenced by subscription

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<sup>41</sup> In a February 14, 1995 memorandum from John Gersten, Compliance Officer, to Bill McKee regarding a Response to a January 23, 1995 NASD Compliance Memo, Mr. Gersten writes “Any accounts approved

agreement must have procedures for the review and endorsement of those transactions to comply with Rule 3010(d).

The evidence admitted establishes that several WBSI customers purchased ISSI shares pursuant to a subscription agreement, and that no principal at WBSI evidenced supervisory review of those subscription transactions. (CX 21). Respondent testified that while he was employed at WBSI he had never heard of ISSI and was completely unaware of any bridge loan or subscription agreements. (Tr. 294). Respondent emphasized that any activity relating to an ISSI transaction and any customer subscription agreements would have been handled exclusively by the firm's Corporate Finance Department, which was under the immediate supervision and control of William McKee. (Tr. 295).

Respondent further testified that WBSI's policies and procedures were designed to be applicable to all transactions "taking in public monies for investment." (Tr. 296). Respondent also testified that "William McKee specifically reserved the management as principal and president of the firm for activities that took place within corporate finance." (Tr. 297).<sup>42</sup>

The Hearing Panel finds Respondent's testimony concerning Mr. McKee's control over the Corporate Finance Department credible. His testimony is consistent with other documentary evidence. In particular, in a September 18, 1996 letter from Gary Sherman, President, and William McKee, Chairman, to Chris Sarno of the NASD Regulation staff, the firm stated ... "Bill McKee continues to accept supervisory

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for naked option trading would be mailed the "Special Statement for Uncovered Option Writers." (RX 18 at 100474).

<sup>42</sup> Respondent also noted that the Corporate Finance Department had its own budget, secretarial staff, office space, and that William McKee "maintained it as a separate entity." (Tr. 297).



responsibility of corporate finance in regards to the ISSI Bridge Financing private placement...” (CX 9 at 1).<sup>43</sup> During cross-examination, Respondent acknowledged that during the period of the ISSI private placement in September 1994 he was designated as the firm’s principal with responsibility for reviewing orders, and that orders effected via subscription agreement were not excluded. (Tr. 402). The Hearing Panel nevertheless has determined that responsibility for reviewing subscription agreements within the Corporate Finance Department rested with William McKee, and that Respondent in fact played no role. Consequently, Respondent is not liable for the charges contained in Cause Six.

G. Cause Seven: The Diehl Graphsoft Offering

With respect to Cause Seven, the Parties stipulated that six WBSI customers paid \$5.00 in miscellaneous and postage charges in connection with the Diehl Graphsoft offering, and that those fees were not disclosed in the prospectus. As a result, those six WBSI customers paid a price that exceeded the public offering price for Diehl Graphsoft shares, which is in violation of Conduct Rule 2110.

Respondent testified that WBSI had changed clearing firms from Southwest Securities to Hanifen and that the Diehl Graphsoft offering was the first underwriting Hanifen had handled for WBSI. (Tr. 300-01). Respondent further testified that William McKee had negotiated the firm’s fee and other arrangements with Hanifen. (Tr. 108 and CX 10 at 2-3). Respondent also testified that the six customers were mistakenly charged

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<sup>43</sup> Referring to CX 9 (the September 18, 1996 letter from Messrs. Sherman and McKee), Respondent stated: “It was my understanding, yes, that Bill McKee retained -- insisted on complete control of things that took place in the corporate financing department and did not make me aware of things they were working on.” (Tr. 298).

the \$5.00 fee by Hanifen, the clearing firm. (Tr. 301).<sup>44</sup> When WBSI brought the matter to Hanifen's attention, the customers' accounts were credited.

The Diehl Graphsoft public offering principally was handled by the firm's Corporate Finance Department. (CX 9).<sup>45</sup> Respondent had no involvement in deciding to change clearing firms to Hanifen Imhoff. William McKee made this decision, and negotiated the firm's service and fee schedule with Hanifen Imhoff. The Hearing Panel determined that six WBSI customers were charged \$5.00 in postage and miscellaneous fees because of a clearing firm error. Enforcement has not persuaded the Hearing Panel that Respondent was in any way responsible for this mistake. Consequently, the Hearing Panel concludes that the Respondent was not liable for the allegations contained in Cause Seven of the Complaint.

### **III. Sanctions**

The Sanction Guidelines<sup>46</sup> provide that the appropriate sanction for an individual found to have violated NASD Conduct Rules 2110 and 3010 because of deficient written

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<sup>44</sup> "Out of the -- I don't know -- probably 200 tickets written, somehow five of them -- or six of them got charged with this postage and handling charge. And I don't remember whether we spotted it or the NASD spotted it, but it was brought to Gary Sherman's attention who, at that point, was ramrodding the deal. In fact, I believe he's the one who initialed all the tickets that came in for it. And we immediately called Hanifen and said, "What are you doing? This is an offering." They said, "Sorry. We'll correct it right now. Credit the accounts back." (Tr. 301).

<sup>45</sup> ... "Bill McKee and Jeff Janda were co-managers on the deal. They agreed to a delineation of duties with Bill [McKee] responsible for the underwriting and Jeff [Janda] responsible for the closing documents and disposition of shares. As each was a principal (series 24), and equally informed of the other's activities, they supervised one another." (CX 9 at 2) (Gary Sherman and William McKee letter to NASD).

<sup>46</sup> The National Adjudicatory Council (formerly known as the National Business Conduct Committee) establishes and periodically revises sanction guidelines so that member firms may become more familiar with some of the typical securities industry violations and the disciplinary sanctions that may result. The Sanction Guidelines serve as a guide to adjudicators in an effort to achieve greater consistency, uniformity, and fairness when imposing sanctions.

supervisory procedures is a fine of \$1,000 to \$25,000.<sup>47</sup> No suspension or other sanction generally is recommended. In addition to the principal considerations adjudicators generally should consider,<sup>48</sup> the Sanction Guidelines provide that adjudicators specifically should consider whether deficiencies in written supervisory procedures allowed violative action to occur or escape detection, and whether the deficiencies made it difficult to determine the persons responsible for specific areas of supervision.

The Hearing Panel in this proceeding believes that the appropriate remedial sanction is a Letter of Caution. Although the Panel found that Respondent Johnston was responsible for WBSI's deficient written supervisory procedures for the January 1 - February 15, 1995 period,<sup>49</sup> the Hearing Panel believes that a sanction below that called for in the NASD's Sanctions Guidelines is appropriate for several reasons.

First, although the NAC has considered a letter of caution to be an inadequate sanction for supervisory deficiencies in cases involving serious sales practice violations,

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<sup>47</sup> NASD Sanction Guidelines (May 1998) at 90.

<sup>48</sup> See *id.* at 8-9.

<sup>49</sup> The Panel found WBSI's written supervisory procedures to be deficient in seven of the nine areas charged in Cause Five of the Complaint: not including an accurate and current designation of supervisors and principals; not including provisions for the handling of cash receipts; not including provisions for the review or inspection of branch offices; not including provisions for the supervision of sales activities reasonably designed to achieve compliance with the penny stock rules; not addressing the reports that the firm's Compliance Registered Options Principal submits to senior management; and not including provisions relating to uncovered short options transactions.

such as unsuitable recommendations and churning,<sup>50</sup> NASD Regulation disciplinary committees have issued letters of caution for inadequate written supervisory procedures in circumstances similar to the case at hand.<sup>51</sup> Specifically, the NAC has found a letter of caution to be an appropriate sanction in supervisory deficiency cases not involving customer related transactions.<sup>52</sup> Furthermore, the NAC has found that a letter of caution may be an appropriate sanction where a respondent, rather than being a direct supervisor of a person who violates the securities laws or the rules of the Association, is in a position, such as the firm's compliance officer, with a less direct supervisory role, and is one of several respondents charged with misconduct in a disciplinary proceeding.

In the instant case, the Hearing Panel did not find Respondent responsible for supervisory deficiencies involving abusive or improper sales practices. Further, Respondent did not fail to reasonably supervise any particular person. Rather Respondent

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<sup>50</sup> See, e.g., District Business Conduct Committee For District No. 8 v. James Allen Merten and City Securities Corporation (Complaint No. C8A950030), 1997 NASD Discip. LEXIS 71 (October 31, 1997) (NAC increased DBCC letter of caution to a censure where the supervisory deficiency, among other things, related to unsuitable recommendations), District Business Conduct Committee For District No. 1 v. Rene R. St. Pierre, Wedbush Morgan Securities, Inc., et al (Complaint No. C01910025), 1994 NASD Discip. LEXIS 62 (May 19, 1994 (NAC increased letter of caution to censure and fines where deficient supervisory procedures related to churning of customer accounts in branch office).

<sup>51</sup> See, e.g., District Business Conduct Committee No. 7 v. Palm State Equities, Inc. (Complaint No. Atl-1216) (July 23, 1991) (decision served as a letter of caution to Palm State regarding its failure to establish and enforce supervisory procedures that would have enabled it to exercise proper supervision in the assignment of each registered representative to a principal, the designation of an appropriately registered principal for the supervision of each type of business conducted by the firm, the qualification of supervisory personnel and the designation of a named principal for the ongoing review and revision of the firm's procedures).

<sup>52</sup> See, e.g., District Business Conduct Committee for District No. 3 v. Smith Benton and Hughes, Inc. et al (Complaint No. C3A950073), 1997 NASD Discip. LEXIS 57 (December 29, 1997) (NAC reduced sanction to a letter of caution where it affirmed DBCC findings relating to books and records and supervisory procedures); District Business Conduct Committee for District 2S v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al, (Complaint No. LA-4154), 1989 NASD Discip. LEXIS 33 (April 26, 1989)(NAC reduced District Committee sanction of a firm censure to a letter of caution with respect to the firm's procedures for compliance with the Free-Riding Interpretation).

failed to adequately revise WBSI's written supervisory procedures to address NASD Regulation staff's concerns. In addition, the Panel concluded that Respondent's responsibility for the deficient supervisory procedures did not allow violative conduct to escape detection.<sup>53</sup>

The Panel also found additional mitigating circumstances. First, Respondent was responsible for WBSI's written supervisory procedures for only part of the period charged in Count Five. Respondent ceded his compliance duties and his responsibilities for the firm's written supervisory procedures around February 15, 1995. Respondent therefore was responsible for the firm's procedures for only one half of the three month period covered in Cause Five of the Complaint.

Second, after agreeing to assume the firm's Compliance Officer duties on a temporary basis when becoming associated with WBSI, Respondent discovered significant problems in WBSI's New York branch office, and took prompt action. Respondent terminated registered representatives and ultimately determined that WBSI's continued viability required that the New York branch be closed. After the June 1994 examination exit conference, when Respondent became aware of NASD Regulation staff's general concerns about WBSI's written supervisory procedures and the specific areas considered deficient, he undertook to revise the firm's written supervisory procedures. Although Respondent's modifications to WBSI's policy and procedures did not remedy the deficiencies, Respondent believed he was adequately responding to NASD Regulation

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<sup>53</sup> Enforcement failed to establish a nexus between the deficient supervisory procedures for which Respondent was responsible and any underlying violative conduct that gave rise to this proceeding.

staff's concerns. These actions demonstrate that Respondent took his compliance responsibilities seriously and attempted to address regulatory issues.<sup>54</sup>

Third, Respondent suffered health problems in September 1994 that affected his ability to carry out his compliance responsibilities. Messrs. Gersten and Sherman assumed on site compliance responsibility for WBSI while Respondent remained at home in San Diego for several weeks. Respondent's physicians restricted his travel, prescribed medication and counseled him to reduce his stress levels, which precipitated his decision to advise Messrs. McKee and Sherman that he was giving up his compliance responsibilities. (Tr. 242-43, 245-46, and 417-20).

Respondent has been in the securities industry for approximately 30 years, and has no disciplinary history. In addition, although responsible in part for WBSI's deficient written supervisory procedures, Respondent certainly was not solely responsible. William McKee, the firm's Chairman, exercised significant control over all aspects of the firm's business.

Respondent was responsible, at least in part, for deficiencies in WBSI's written supervisory procedures relating to principal designations, which caused NASD Regulation staff some difficulty in identifying which persons at WBSI were responsible for various activities at different times. The Panel concluded that others at WBSI were principally responsible for this problem and, therefore, did not view Respondent's role as an important consideration. Having considered all the above-referenced circumstances, the Panel believes that a letter of caution to Respondent is the appropriate sanction.

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<sup>54</sup> RX 17 at 100457-458, ¶ 3. This February 8, 1995 Memorandum from Ronald Johnson to William McKee describes how WBSI responded to the deficiencies NASD Regulation staff identified in the 1994

#### IV. Conclusion

The Hearing Panel found that Respondent violated Rule 3010 in connection the firm's written policies and procedures relating to seven of the nine specifically alleged deficiencies contained in Cause Five, namely: not including an accurate and current designation of supervisors and principals; not including provisions for the handling of cash receipts; not including provisions for the review or inspection of branch offices; not including provisions for the supervision of sales activities reasonably designed to achieve compliance with the penny stock rules; not addressing the reports that the firm's Compliance Registered Options Principal submits to senior management; and not including provisions relating to uncovered short options transactions. The Hearing Panel found that Respondent was not responsible for the firm's policies and procedures relating to the review of customer subscription agreement transactions or for the undisclosed miscellaneous postage and handling fees. The Hearing Panel determined that the appropriate sanction was a letter of caution, and assessed costs against Respondent in the amount of \$1,447.30, consisting of a \$300 administrative fee and \$1,147.30 for the cost of the hearing transcript.<sup>55</sup>

Hearing Panel

by: \_\_\_\_\_  
Joseph M. Furey  
Deputy Chief Hearing Officer

Copies to: Peter Shenan, Esq. (via first class mail and Federal Express)  
Ronald V. Johnston (via first class and certified mail)

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WBSI examination, which would be discussed at the February 16, 1995 Compliance Conference. See also RX 19 at 100012 ¶2 and 5.

<sup>55</sup> The Panel considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.

Rory C. Flynn, Esq. (via first class mail)  
Jacqueline D. Whelan, Esq. (via first class mail and Federal Express)