BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. Chris Dinh Hartley San Jose, CA, Respondent.	DECISION Complaint No. C01010009 Dated: December 3, 2003

Respondent violated NASD Conduct Rules 3040 and 2110 by participating in the offer and sale of promissory notes to five customers without prior written notice to, and approval of, his employer. Held, Hearing Panel's findings are affirmed and sanctions are affirmed in part and modified in part.

Appearances

For the Complainant: David A. Watson, Esq., NASD Department of Enforcement.

For the Respondent: Chris Dinh Hartley, Pro se.

Opinion

We called this matter for review pursuant to NASD Procedural Rule 9312 to examine various aspects of the sanctions. After a review of the record in this matter, we affirm the Hearing Panel's findings that Hartley violated Conduct Rules 3040 and 2110 by participating in the offer and sale of promissory notes for compensation to five customers without prior written notice to, and written approval of, his employer. We affirm the Hearing Panel's sanctions in part and modify them in part. We affirm the imposition of a $7,500 fine and $2,059.86 in costs. We increase the suspension that the Hearing Panel imposed from 30-calendar days to 90-calendar days.

I. Background

Hartley began working for Pruco Securities Corporation ("Pruco") in November 1987. From April 1988 until December 1999, Hartley was registered with Pruco and the Prudential Insurance Company of America ("Prudential Insurance") as an investment company products and variable contracts representative. Hartley was dually employed and registered with Pruco and Prudential Insurance until May 1996, after which Hartley was registered only with Pruco. In March 1998, Hartley became registered as a general securities representative with Pruco. Hartley left Pruco on December 31, 1999. Since January 6, 2000, Hartley has been registered as a general securities representative with another member firm.

II. Facts

From approximately September 21, 1996, through January 10, 1997, Hartley participated in the offer and sale of five promissory notes issued by First Lenders Indemnity Corporation ("FLIC") to five investors for total proceeds to FLIC of $255,500.[1] Hartley did not give written notice to, or obtain written permission from, Pruco before selling the notes.

In 1996, Hartley primarily sold life insurance and variable annuities for Pruco and other insurance entities.[2] Hartley was not a "captive agent,"[3] and like the other investment company and variable products representatives at Pruco who were not captive agents, Hartley informed Pruco of his outside commercial relationships at Pruco's annual compliance meeting, which usually occurred at the end of each year. It was common practice for non-captive agents to have a list of outside entities for which they were selling life insurance and annuities and for the agents to update their Uniform Applications for Securities Industry Registration or Transfer ("Form U4s") after the annual compliance meeting each year to reflect outside business activities.[4] In 1996, Pruco held its annual compliance meeting in August.

Hartley first learned of FLIC that same month when Randy Scianna ("Scianna"), a principal owner of the Individual Retirement Account Center & Insurance Services, invited Hartley to come to a presentation about FLIC notes. At the presentation, Scianna suggested that Hartley sell FLIC promissory notes and he provided Hartley with FLIC's Dun & Bradstreet Business Information Report, dated August 6, 1996. According to FLIC's Disclosure Document, which was used to solicit purchase of the notes, FLIC was formed in April 1995 to "underwrite,

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[1] Hartley received funds from one of these customers in January 1997, but he returned that customer's funds before the note was purchased.

[2] Hartley earned only $2,000 in commissions for the sale of mutual funds in 1996.

[3] A "captive agent" is required to sell only the products of the firm with which he or she is employed. Because Hartley was not a "captive agent," he was free to sell other firms' products.

[4] We do not make a determination about whether Pruco's procedures complied with NASD rules.

purchase, service and resell retail automobile installment loan contracts ('Vehicle Loans or Contracts') in the commercial market." The Disclosure Document also stated that FLIC "believes that the notes are exempt securities pursuant to Section 3(a)(3) of the Securities Act of A1933 [sic]." According to Hartley, Scianna assured him that the notes were not securities and that one did not need a securities registration to sell the notes.[5] During the hearing before the Hearing Panel, Scianna testified that Bank One had told him that the notes were exempt securities and that he had told Hartley that "they were exempt securities and that they were the same as an FLIC-insured-type CD," which could be sold by anyone. Hartley believed that Scianna had a good reputation in the industry, and based upon that and Sciannia's representation concerning the product, including his representations concerning the status of the product under the Securities Act, Hartley decided to offer the FLIC notes to his customers.

On September 9, 1996, several weeks after Pruco's annual compliance meeting, Hartley signed an agent agreement to sell the FLIC notes. Based on Scianna's good reputation in the insurance industry, Hartley had decided to offer the FLIC notes to his customers. The agent agreement called the FLIC notes "a Commercial Paper issue." Hartley also signed a "Representative's Compliance Declaration" that same day. In signing this declaration, Hartley represented to FLIC that he had "notified [his] Broker/Dealer of [his] participation in providing this exempt security to [his] clients" and that "[i]n the eyes of [his] Broker/Dealer [he was] in complete compliance." At that time, however, Hartley had not notified anyone at Pruco about his intended participation in the offering of the FLIC notes.

Later that month, Hartley told his supervisor, Marlene Kasparian ("Kasparian"), that he was selling nine-month promissory notes for FLIC. Hartley asked Kasparian if she would be interested in purchasing one of the notes. She declined.

From September 1996 through January 1997, Hartley sold $255,500 worth of FLIC notes to five clients, two of whom were Pruco's clients. The Pruco clients purchased the FLIC notes with money from their checking accounts rather than from their Pruco accounts.

The FLIC notes paid 10% interest and had a term of nine months. The minimum note purchase was one note for $25,000. Note purchasers had a 10-day right-of-refusal period during which they could return their notes for a refund. FLIC was trying to sell up to $50,000,000 of notes and purported to be using the net proceeds from the offering to finance the purchase of loans secured by perfected liens on new and used vehicles.

Hartley stated that his clients purchased the FLIC notes because "they want[ed] to earn better than CD, saving [sic] account or money market [sic] for a short-term period."[6] Hartley's clients received their monthly interest on the notes until mid-January 1997, when they began complaining to Hartley about missed payments. Hartley called Scianna, who told Hartley to stop doing business with FLIC. Scianna told Hartley that he suspected FLIC officers were

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[5] Scianna and his company sold only fixed rate annuities and life insurance.

[6] CDs were offering about 7% to 8% interest at the time.

misappropriating funds.[7] Hartley followed Scianna's advice, including returning to one customer funds intended for investment in the FLIC notes.

On April 4, 1997, Scianna filed a compliant about FLIC with the Department of Corporations for the State of California. Scianna and others forced FLIC into bankruptcy later that month. The U.S. Bankruptcy Court for the Central District of California later determined that FLIC had run a Ponzi scheme, whereby FLIC paid interest due to investors with the funds received from more recent investors who purchased notes.

After Pruco's annual compliance meeting in November 1997,[8] Hartley amended his Form U4 to reflect that he had been engaged in outside business activities with FLIC during that year. Hartley told his compliance officer, Sue Korp ("Korp"), that from September 1996 through January 1997 he had sold FLIC promissory notes and that these promissory notes were secured by automobile loans. Korp told Wayne Stoeber ("Stoeber"), the interim managing director of the office, about the notes that Hartley had sold. Stoeber approved Hartley's amended Form U4 that month.

Almost two years later, on August 20, 1999, Hartley received a letter from the bankruptcy attorney for the trustee in bankruptcy of Boston Acceptance Corporation f/d/b/a FLIC. The letter informed Hartley that the U.S. Bankruptcy Court for the Central District of California had authorized suit to recover all commissions paid in connection with the sale of FLIC promissory notes. Hartley remitted his commissions promptly.[9]

After Hartley received the August 20, 1999 letter, Pruco began an internal review of Hartley. Hartley resigned from Pruco on December 30, 1999, apparently before Pruco completed its investigation. In January 2000, Pruco filed a Uniform Termination Notice for Securities Industry Registration ("Form U5") disclosing Hartley's resignation and noting its internal investigation of Hartley. NASD staff commenced its investigation of Hartley after receiving the Form U5. NASD staff sent a request for information to Hartley on August 8, 2000, and on August 20, 2000, Hartley provided a written response.

On October 1, 2001, NASD's Department of Enforcement ("Enforcement") filed a complaint against Hartley alleging that he violated Rule 3040. On October 29, 2001, Hartley filed an answer to the complaint, admitting participation in the sale of FLIC promissory notes to

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[7] In March 1997, Scianna's assistant wrote Hartley a letter suggesting that Hartley not conduct business with FLIC until Scianna could determine why FLIC had suspended payments. Hartley had not sold any FLIC notes since January 6, 1997.

[8] This apparently was the first such meeting since August 1996.

[9] Although Schedule A to the complaint indicates that Hartley made $8,320 in commissions from his sales of FLIC notes, FLIC's records (according to the bankruptcy receiver's attorney) stated that Hartley received $7,780 in commissions. The difference is immaterial for purposes of this case.

five customers without providing written notification to Pruco, but stating that the notes were not securities and, in any event, he had provided verbal notice of the sales to Pruco. On November 5, 2002, the Hearing Panel issued its decision, finding that Hartley had participated in the offer and sale of promissory notes for compensation to five customers without prior written notice to, and approval of, his employer in violation of NASD Rules 3040 and 2110. The Hearing Panel fined Hartley $7,500, suspended him from associating with any member firm in any capacity for 30 calendar days, and ordered Hartley to pay $2,059.86 to cover the costs of the hearing. On December 18, 2002, we called the matter for review to examine the sanctions imposed by the Hearing Panel. Both parties filed briefs. Hartley did not request a hearing. The case was therefore decided on the record.

III. Discussion

We called this case for review to examine the sanctions imposed by the Hearing Panel. Because the nature of the violation is relevant to the issue of sanctions, however, we will first examine the Hearing Panel's findings that Hartley violated NASD Rules 3040 and 2110. NASD Rule 3040 prohibits registered representatives from participating in private securities transactions for compensation without first providing written notice to, and receiving written permission from, their employer firm. Hartley argued both before the Hearing Panel and before a National Adjudicatory Council ("NAC") subcommittee ("Subcommittee") that NASD Rule 3040 did not prohibit his conduct because the promissory notes he sold were not "securities." If the notes are not "securities," then Conduct Rule 3040 does not apply to the transactions that Hartley entered into with his customers. On the other hand, if the promissory notes were "securities," then Hartley's sale of the notes violated Rule 3040.

We have reviewed the record, the parties' briefs and the well-established case law, and we affirm the Hearing Panel's finding that Hartley violated Conduct Rule 3040 by engaging in private securities transactions for compensation without properly informing his employer and without receiving written permission from his employer.

A. The Promissory Notes Were "Securities"

In Reves v. Ernst & Young, 494 U.S. 56 (1990), the United States Supreme Court held that Congress's intent in drafting the Securities Exchange Act of 1934 (the "Exchange Act") "was to regulate investments, in whatever form they are made and by whatever name they are called." Id. at 61. Therefore, Congress defined "'security' sufficiently broad[ly] to encompass virtually any instrument that might be sold as an investment." Id. Section 2(1) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(10) of the Exchange Act (collectively, the "Securities Acts") define a "security" as any one of a long list of financial instruments, beginning with "any note." Courts, however, have not interpreted Section 3(a)(10) to cover literally "any note," but rather only those notes that, in keeping with the congressional purpose of the Exchange Act, are deemed to be investments in need of regulation.[10]

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[10] The Supreme Court has held consistently that "'the definition of a security in §3(a)(10) of the [Exchange] Act . . . is virtually identical [to the definition in the Securities Act of 1933] and,

[Footnote continued on next page…]

The Supreme Court in Reves developed the "family resemblance" test for determining whether a particular note is in need of regulation and should therefore be deemed a "security" for purposes of federal securities laws and regulations. Under this test, every note is presumed to be a security, unless it bears a strong resemblance to one of several expressly enumerated types of notes generally recognized as falling outside the definition of "security" under the Securities Acts. The following types of notes are excluded from the definition of "security": a note delivered in consumer financing, a note secured by a mortgage on a home, a note with a maturity not exceeding nine months that is secured by a lien on a small business or some of its assets, a note evidencing a "character" loan to a bank customer, a note with a maturity not exceeding nine months that is secured by an assignment of accounts receivable, a note that simply formalizes an open-account debt incurred in the ordinary course of business, or a note evidencing a loan by a commercial bank for current operations. Reves, 494 U.S. at 65.

Although the FLIC notes had a maturity period of nine months, we do not find that they should be excluded from the definition of "security" under the short-term note exception. Congress did not intend the exemption to cover all short-term notes. The legislative history of the Securities Act makes clear that the exemption "was meant to apply to 'short term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors.'" S.E.C. v. R.G. Reynolds Enter., Inc., 952 F.2d 1125, 1132 (9th Cir. 1991) (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933)). Indeed, many courts have generally limited the short-term note exception to commercial paper.[11] See, e.g., Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795, 800 (2d Cir.), cert. denied, 414 U.S. 908 (1973) ("The mere fact that a note has a maturity of less than nine months does not take the case out of [the Securities Acts], unless the note fits the general notion of 'commercial paper.'").[12]

Hartley stated that FLIC had called the notes "commercial paper," and he therefore had not considered the notes to be "securities." However, "[i]t is not the moniker or label that is dispositive, but the economic characteristics of the notes." S.E.C. v. J.T. Wallenbrock and Assocs., 313 F.3d 532, 536 (9th Cir. 2002); see also Prime Investors, 53 S.E.C. 1, 10 (1997) (stating that "applicant's denomination of the notes" as personal loans did not insulate them from

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for present purposes, the coverage of the two Acts may be considered the same." Reves, 494 U.S. at 61 n.1 (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975)).

[11] The Supreme Court in Reves left open the issue of whether the short-term note exclusion applies only to commercial paper. Reves, 494 U.S. at 71.

[12] See also Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485, 1489 (10th Cir.), cert. denied, 498 U.S. 958 (1990); Baurer v. Planning Group, Inc., 669 F.2d 770, 776 (D.C. Cir. 1981); McClure v. First Nat'l Bank, 497 F.2d 490, 494-95 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975); Sanders v. John Nuveen & Co., 463 F.2d 1075, 1080 (7th Cir.), cert. denied, 409 U.S. 1009 (1972).

coverage by the securities laws).[13] If the economic realities of the transaction are such that investors are in need of protection, then for purposes of the securities laws, the notes will be deemed "securities" regardless of whether they have a maturity period of nine months or less. R.G. Reynolds Enters., Inc., 952 F.2d at 1133. In this case, the short-term maturity period of the FLIC notes did not reduce the risk of the notes. We find that the FLIC notes were therefore in need of regulation under the Securities Acts and were not the kind of short-term notes covered by the exemption.

Having found that the FLIC notes were not sufficiently similar to one of the statutorily enumerated exempt notes, we must now consider the following four factors to determine whether the note is of a type that should be added to the list: (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (2) the instrument's plan of distribution to determine whether it is an instrument in which there is common trading for speculation or investment; (3) whether the investing public would reasonably expect the instrument to be considered a security; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering the application of the Securities Acts unnecessary.

Factor One: Motivation of the Parties. The Supreme Court in Reves explained that "[i]f the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'" Reves, 494 U.S. at 66. If, on the other hand, "the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose . . . [then] the note is less sensibly described as a 'security.'" Id.

In this case, we find that the "economic characteristics" of the notes make clear that they were "securities." FLIC sold the notes ostensibly to raise money to conduct its purported regular business, which was the purchase and resale of automobile installment loan contracts. We therefore find that FLIC raised money "for the general use of a business enterprise." Reves, 494 U.S. at 66.

We must also examine the evidence to determine the customers' reasonable expectations and motivations in buying the notes. Hartley testified that his clients purchased the FLIC notes because they would earn more from the notes, which paid 10% interest, than they would from CDs, which were then paying about 7% or 8% interest, or through their savings or money market accounts. Indeed, courts and the Commission have noted that favorable interest rates indicate

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[13] Hartley also stated that he did not think the notes were securities because Scianna had told him that the notes were not securities. A registered representative, however, may not rely on a colleague's interpretation of whether a particular transaction is covered by NASD Rule 3040. See Gilbert M. Hair, 51 S.E.C. 374, 377 (1993) ("A registered representative's reliance on informal discussions with colleagues, rather than an official opinion by appropriate firm personnel, is also an insufficient basis for concluding that a transaction is not subject to [NASD Rule 3040].").

that a profit was the primary goal of the note purchaser. See Robin Bruce McNabb, Exchange Act Rel. No. 43411, 2000 SEC LEXIS 2120 (Oct. 4, 2000) (holding that customers were motivated by desire for profit where interest rates were favorable compared to those expected from money market funds and certificates of deposit).[14] We find that the reasonable motivation for the customers in this case was the desire to earn a profit.

Factor Two: Plan of Distribution. We must also determine whether these notes are instruments in which there is "common trading." "Common trading" is established "if the instrument is 'offered and sold to a broad segment of the public . . . .'" Stoiber, 161 F.3d at 750 (quoting Reves, 494 U.S. at 68).

In this case, FLIC wanted to raise $50,000,000 through $25,000 notes, which were transferable by the note holder. Thus, although the Disclosure Document represented that FLIC did not advertise the notes or make general solicitations to the public, and although Hartley sold notes to just five customers, Scianna estimated that there were 400 agents selling notes and 4,000 note holders. The broad distribution that FLIC sought tips this factor in favor of finding the requisite plan of distribution. Indeed, the Commission has previously held that the sale of as few as five notes to the public satisfies this prong of the Reves test. See Robin Bruce McNabb, 2000 SEC LEXIS 2120, at *13 (citing Trust Co. v. N.N.P., Inc., 104 F.3d 1478, 1489 (5th Cir. 1997) ("A debt instrument may be distributed to but one investor, yet still be a security.")).

Factor Three: Public Expectations. The Supreme Court in Reves made clear that it would consider financial instruments to be "securities" based on public expectations, even where an economic analysis of the transaction might suggest otherwise. 494 U.S. at 66. This factor "generally turns on whether [the notes] are reasonably viewed by purchasers as investments." Stoiber, 161 F.3d at 751 (citing Reves, 494 U.S. at 68-69). This is an objective determination, and we must focus on "what a 'reasonable investor' would think, not what the 'specific individuals in question' might have thought." S.E.C. v. J.T. Wallenbrock and Assocs., 313 F.3d at 539 (quoting McNabb, 298 F.3d at 1132).

We find that this factor weighs in favor of categorizing the notes as securities. Although the purchaser agents were prohibited from calling the FLIC notes "investments" and were required to call them "commercial paper," a reasonable investor giving funds to receive a guaranteed return of 10%—several percentage points better than certificates of deposit—would consider that the funds were an investment. The fact that FLIC did not use the term "investment" in its Disclosure Document is not determinative. See Wallenbrock and Assocs., 313 F.3d at 539 (finding that reasonable investors would view the notes as an investment even though the issuer did not use the term "investment").

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[14] See also Stoiber v. S.E.C., 161 F.3d 745, 750 (1998), cert. denied, 526 U.S. 1069 (1999) (stating that favorable interest rate "indicates that profit was the primary goal of the lender") (citing Reves, 494 U.S. at 67-68); Frank Thomas Devine, Exchange Act Rel. No. 46746, 2002 SEC LEXIS 2780, at *16 (Oct. 30, 2002) (holding that motivation factor was satisfied where investors purchased promissory notes with expectation of profitable return).

Factor Four: Another Regulatory Scheme That Significantly Reduces Risk. We recognize that the California Department of Corporations had some regulatory authority over the notes and issued a Desist and Refrain Order precluding FLIC from continuing to sell them. "[T]hat remedy offers little solace to existing investors," however, and "a patch-work of state regulation, which applies to most business entities in some fashion or another, cannot displace the federal regime." Wallenbrock and Assocs., 313 F.3d at 540. We conclude that there is no other regulatory regime that reduces the risk of the notes in this case, and therefore holders of these notes needed the protection of the federal securities laws.

B. "Written Notice" of the Private Securities Transactions

Having established that the promissory notes were "securities," we must now determine whether Hartley violated NASD Rules 3040 and 2110 when he participated in their sale.[15] Rule 3040 requires an associated person to provide his or her employer with written notice of private securities transactions. Stephen J. Gluckman, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395 (July 20, 1999). This notice must be provided before the transactions take place. See NASD Conduct Rule 3040(b). Furthermore, the Commission has held that the notice must describe the transaction "in detail," which requires, at a minimum, the identification of the investor and the amount of money invested. William Louis Morgan, 51 S.E.C. 622, 627 n.19 (1993). Moreover, if the associated person is compensated for the transactions, the associated person must receive the firm's written permission before he or she engages in these transactions. See NASD Conduct Rule 3040(c).

Hartley argues that he twice gave notice to Pruco: first, in September 1996, when he told Kasparian, his supervisor, about the FLIC notes, and again in November 1997, when he amended his Form U4 to reflect his outside business activities with FLIC. When he amended his Form U4, Hartley also explained to Korp, his compliance officer, that he had sold promissory notes for FLIC. Korp told Stroeber, the office's interim managing director, about the notes and Stoeber approved Hartley's amended Form U4 later that month. The Hearing Panel found credible Hartley's testimony that he gave verbal notice of the notes to Kasparian and Korp.[16] We accept the Hearing Panel's finding. See, e.g., Jonathan Garrett Ornstein, 51 S.E.C. 135, 137 (1992) (citing Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951)) (credibility determinations of an initial fact-finder are entitled to considerable weight and deference, since they are based on hearing the witnesses' testimony and observing their demeanor).

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[15] The NASD's finding that Hartley violated Rule 2110 "is in accord with our long-standing and judicially-recognized policy that a violation of another Commission or NASD rule, including Conduct Rule 3040, constitutes a violation of Conduct Rule 2110." Stephen J. Gluckman, Exchange Act Rel. No. 41628 (July 20, 1999).

[16] Korp corroborated Hartley's testimony. Kasparian could not recall whether she had had a conversation with Hartley about the FLIC notes.

Although Hartley gave verbal notice of his participation in the sale of FLIC notes in September 1996, he failed to give the kind of notice, and receive the kind of permission, required by NASD Rule 3040. First, Rule 3040(b) requires the representative to give written notice that explains each transaction in detail. See Jim Newcomb, Exchange Act Rel. No. 44945, 2001 SEC LEXIS 2172, at *17 (Oct. 18, 2001) (holding that "furnishing notice in writing is necessary for compliance with [Rule 3040]") (quoting Dale M. Russell, 51 S.E.C. 561, 563 n.9 (1993)). It is undisputed that Hartley mentioned the notes to his supervisor, but did not provide Pruco with the kind of detailed written notice that the rule requires. Second, Rule 3040 requires the representative to give the detailed written notice before he or she participates in the transactions. In this case, Hartley did not give his first written notice of his involvement with FLIC until November 1997, 10 months after he sold his last FLIC note to a customer. Even then, Hartley merely listed "FLIC" as one of the entities with which he was involved outside of Pruco, and he did not provide the detailed information about the nature of his involvement with FLIC that Rule 3040 requires. Third, it is undisputed that Hartley received "selling compensation" in the form of commissions from his sale of the FLIC notes. Rule 3040 states unequivocally that a representative who receives selling compensation from participation in private securities transactions must not only give written notice to the firm but must also receive written permission from the firm before engaging in the transactions.

We therefore find that the November 1997 amendment to Hartley's Form U4 did not satisfy the notice requirement under Rule 3040. See Gordon Wesley Sodorff, 50 S.E.C. 1249, 1253 (1992) (stating that Rule 3040 requires a representative to give sufficient information to enable the firm to evaluate the proposed transaction, and anything short of a complete description does not satisfy the requirements of the rule). Hartley's failure to give proper written notice to, and to receive written permission from, Pruco constitutes a violation of Rule 3040.

IV. Sanctions

The Hearing Panel ordered that Hartley be fined $7,500, suspended in all capacities for 30 calendar days, and ordered to pay costs of $2,059.86. Although we agree with the Hearing Panel that this is not an egregious case, we find that the Hearing Panel's suspension is too brief given the seriousness of private securities transaction violations, the mitigating and aggravating factors in this case, and the sanctions in other recent cases.[17] We therefore affirm the $7,500 fine, but we increase the suspension in all capacities from 30 calendar days to 90 calendar days.[18]

The 2001 edition of the NASD Sanction Guideline ("Guideline") for Private Securities Transactions provides for fines ranging from $5,000 to $50,000 and a suspension in any or all capacities for a period of 10 days to one year or, in egregious cases, a suspension of up to two

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[17] See Dept. of Enforcement v. Roger A. Hanson, Complaint No. C8A000059, 2002 NASD Discip. LEXIS 5, at *12-13 (NAC Mar. 28, 2002); Dept. of Enforcement v. Luther A. Hanson, Complaint No. 9A000027, 2001 NASD Discip. LEXIS 41, at *23 (NAC Dec. 13, 2001).

[18] In its brief to the NAC, Enforcement renewed the recommendation it made to the Hearing Panel that Hartley be fined $10,000 and suspended for four months.

years or a bar.[19] The sanctions we impose reflect both the aggravating and mitigating factors of this case and are reasonable in light of the nature of the violation.

The Guideline lists the following seven factors to consider in determining the proper remedial sanction: (1) whether the respondent had a proprietary or beneficial interest in, or was otherwise affiliated with, the selling enterprise; (2) whether the respondent tried to create the impression that his employer approved the activity by, for example, using the firm's facilities; (3) whether the respondent sold away to his firm's customers; (4) whether the respondent provided verbal notice of all relevant factors to his employer; (5) whether the respondent sold the product at issue after prior rejection by the firm or warning from a supervisor to stop sales; (6) whether the respondent was registered properly to sell the product at issue; and (7) whether the respondent sold the product directly to customers or participated in the sale by referring customers to an appropriately registered individual for purchase.[20]

We find that three of these factors were aggravating. First, Hartley sold away to two of Pruco's customers. Second, because the FLIC notes were "securities," Hartley was required to be registered as a general securities representative at the time he sold them. Hartley, however, did not become registered as a general securities representative until March 1998—more than one year after he sold the FLIC notes. He was therefore not registered properly at the time he sold the notes. Third, Hartley sold the FLIC notes directly to his customers and did not merely participate in the sales by referring the customers to an appropriately registered individual.

Moreover, one the Guidelines' overriding principal considerations in determining sanctions for all violations of NASD Rules is "whether the respondent's misconduct resulted directly or indirectly in injury to . . . other parties," and if so, the "nature and extent of the injury."[21] In this case, FLIC collapsed under the weight of the Ponzi scheme it had created soon after Hartley sold the promissory notes, and Hartley's customers were therefore unable to recover the principal, let alone the interest payments FLIC had promised them.

We also find that there were several mitigating factors. Although Hartley did not provide all of the details of the FLIC transactions, he did tell his supervisor that he was selling the FLIC notes. In addition, in his brief to the NAC, Hartley asserted that Pruco failed to train him and his supervisors properly about what a "security" is and what the proper procedures were for complying with NASD Rule 3040.

At the time of the violation, Hartley was registered as an investment company and variable products representative, and his training at Pruco focused primarily on insurance. The closest Pruco's compliance manual came to defining a "security" is in explaining that the Series 7 general securities examination covers "stocks, bonds, options and tax-shelters." Furthermore, the

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19 See Guideline (2001 ed.) at 19-20 (Private Securities Transactions).

20 The Hearing Panel considered only five of the seven factors.

21 See Guidelines (2001 ed.) at 10 (Principal Considerations in Determining Sanctions).

Pruco manual articulated the prohibition against "selling away" as a restriction on representatives from "participating in the discussion of any securities except Prudential mutual funds, Prudential Pruco Life variable annuities or variable life products, and securities sold through the Advantage and Advantage Investor Accounts." Hartley, however, was not a captive agent and was not prohibited from selling variable products for outside entities. The manual did not explain clearly that the prohibition also applies to non-captive agents who are otherwise not required to sell only Pruco Life variable life products and annuities. Consequently, Hartley followed the reporting procedures for outside business activities.

Moreover, neither of the supervisors whom Hartley told about the notes recognized that the notes could be "securities." The interim managing director was told about the FLIC notes and approved Hartley's amended Form U4, which indicated Hartley's involvement with FLIC. Pruco did not realize that the FLIC notes were an issue until two years later when it received the August 20, 1999 letter from FLIC's bankruptcy trustee.

The Commission and the courts have consistently held that a registered representative is responsible for knowing and abiding by NASD rules and regulations.[22] We do not find that the deficiencies in Pruco's compliance manual and training exonerate Hartley, but they are a mitigating factor.

Finally, the Hearing Panel found that Hartley testified truthfully, cooperated with NASD's investigation, expressed genuine remorse for his violative conduct and promptly remitted his commissions to FLIC's receiver when asked to do so. We accept the Hearing Panel's findings in this regard. Nevertheless, we are troubled that Hartley falsely represented in his FLIC compliance declaration that he had advised Pruco of his participation and had received permission from Pruco to participate in the offering. This compliance declaration also should have put Hartley on notice that greater disclosure to Pruco may have been required.

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[22] See Carter v. SEC, 726 F.2d 472, 473-74 (9th Cir. 1983) (rejecting representatives' defense that they were unaware of NASD rules regarding private securities transactions, stating "[a]s employees, [the representatives] are assumed as a matter of law to have read and have knowledge of these rules and requirements"); Klaus Langheinrich, 51 S.E.C. 1122, 1124-25 (1994) (concluding representative's lack of familiarity with NASD rule governing private securities transactions did not excuse his violation of that rule); Peter K. Lloyd, 51 S.E.C. 200, 202 (1992) (holding that representative was charged with knowledge of NASD rules governing private securities transactions even though his firm's compliance manual did not require prior written notice); Gilbert M. Hair, 51 S.E.C. at 377 n.12 (stating same).

Accordingly, we order that Hartley be fined $7,500; ordered to pay costs of $2,059.86; and suspended for 90 calendar days.[23]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

[23] The recommended sanctions are consistent with the applicable NASD Sanction Guideline. See Guideline (2001 ed.) at 19 (Private Securities Transactions).

We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.