BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of The Department of Enforcement, Complainant, vs. Joseph J. Vastano, Jr. No. Dartmouth, MA, Respondent.	DECISION Complaint No. C3A020013 Dated: December 5, 2003

Respondent participated in private securities transactions, for compensation, without providing prior written notice to, and obtaining written permission from, his employer in violation of Conduct Rules 2110 and 3040. Held, findings affirmed and sanctions modified.

Appearance

For the Complainant: Jacqueline Whelan, Esq., NASD Department of Enforcement.

For the Respondent: John P. Cione, Esq.

Opinion

I. Introduction

The Hearing Panel found that Joseph J. Vastano, Jr. ("Vastano") participated in private securities transactions, for compensation, without providing prior written notice to, and obtaining written permission from, his NASD member firm in violation of Conduct Rules 2110 and 3040. The Hearing Panel suspended Vastano for one year and fined him $62,000. Following this decision, Vastano appealed. We affirm the findings, but modify the sanctions.

II. Background

Vastano first entered the securities industry in January 1987 as an investment company products/variable contracts limited representative (Series 6). From April 1997 to July 2000, L.M. Kohn & Company ("L.M. Kohn") employed Vastano in the same capacity. Vastano is not currently registered with any NASD member firm.

III. Facts

This matter involves Vastano's alleged failure to provide written notice to, or receive written permission from, L.M. Kohn prior to engaging in sales of investments for the Alliance Leasing Corporation ("Alliance Leasing"), as required by Conduct Rule 3040.[1]

A. Alliance Leasing

Alliance Leasing, a Nevada Corporation headquartered in San Diego, operated an equipment-leasing program. Under this program, Alliance would purchase commercial office and kitchen equipment using investor funds and lease the purchased equipment to third-party lessees. According to Alliance Leasing, the company would purchase the equipment in the name of individual investors. Through advertising, Alliance Leasing represented that investors would receive a total return of 28 percent on their investment over a period of 25 months, including a balloon payment at the end of the two years. Alliance Leasing also represented that the product was covered by insurance that would continue lease payments to investors if the lessee defaulted.

In order to facilitate the sale of the program, Alliance Leasing used a pyramid marketing structure. At the top of the pyramid was Prime Atlantic, Inc. ("Prime Atlantic"). Prime Atlantic received a 30 percent commission for its activities. Prime Atlantic then sub-contracted with numerous "master contractors." The master contractors would sub-contract with "managing contractors," who recruited "independent sales contractors." These independent sales contractors sought out investors for the equipment-leasing program. Each level of the pyramid received a portion of Prime Atlantic's 30 percent commission.

Through this sales structure, approximately 1,500 customers invested more than $46 million in the equipment-leasing program. Once collected, Alliance Leasing placed all funds into one account at Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill

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[1] This matter arose out of a Uniform Termination Notice for Securities Industry Registration ("Form U5") filed by an NASD member firm for an individual other than Vastano. In that Form U5, the individual was alleged to have participated in the sale of Alliance Leasing investments. After learning that Alliance Leasing was in bankruptcy, NASD examination staff researched whether any other associated persons or members were involved in selling this product. Through this research, NASD examination staff learned that Vastano sold Alliance Leasing investments to certain customers.

Lynch"). Quickly thereafter, Alliance Leasing would remove funds from the account to pay Prime Atlantic. Of the $46 million collected, Alliance Leasing paid approximately $12 million to Prime Atlantic and other contractors. Alliance Leasing, however, only used $9.3 million to purchase equipment to lease. In fact, Alliance Leasing purchased some of the equipment from, and leased the equipment to, companies associated with Alliance Leasing or owned by principals of Alliance Leasing. Because Alliance Leasing only invested a small percentage of the monies collected to purchase equipment, the company was unable to pay the advertised return to investors. Subsequently, Alliance Leasing entered into bankruptcy proceedings and a trustee was appointed.

In October 1998, the SEC filed suit in the United States District Court for the Southern District of California ("District Court") alleging that Alliance Leasing and Prime Atlantic engaged in securities fraud and distributed unregistered securities in violation of the federal securities laws. On October 7, 1998, the District Court granted a temporary restraining order that prohibited the defendants from violating the federal securities laws and froze their assets held in financial and brokerage institutions. Following the issuance of this order, on November 19, 1998, the District Court imposed a preliminary injunction against Prime Atlantic and Alliance Leasing from violating the federal securities laws. On March 17, 2000, the District Court granted the SEC's motion for summary judgment. In that decision, the District Court found that the Alliance Leasing investments were securities and that Prime Atlantic and the owners of Alliance Leasing violated the federal securities laws.[2]

B. Vastano's Sales of Alliance Leasing

On May 13, 1998, Vastano executed an Independent Sales Agreement with Unlimited Financial Services, Inc., a managing contractor for Alliance Leasing that was controlled by Clyde Morgan ("Morgan"). Morgan participated in the Alliance Leasing program through his master contractor Otto Jarrell, who did business under the name LifeQuest Advisors. Under his independent sales agreement, Vastano received an 11 percent commission on each $10,000 Alliance Leasing "unit" he sold.

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[2] The District Court declined to give any weight to a legal opinion by Laurence Leafer, Esq. ("Leafer") that the Alliance Leasing program was not a security because Leafer was an interested party. The District Court also considered an alleged oral opinion from the law firm of Baker & Hostetler that the program was not a security. While the District Court questioned whether the law firm actually rendered such an opinion, it assumed that Baker & Hostetler did because the District Court was ruling on a motion for summary judgment. In any event, the District Court found that any reliance on the alleged oral opinion terminated on March 27, 1998, when Baker & Hostetler sent a letter stating that the Alliance Leasing program could be deemed a security by certain state regulators. The record in this matter only contains the Leafer opinion letter.

From June 4, 1998 to September 15, 1998, Vastano sold Alliance Leasing investments to 14 investors for $358,000.[3] These sales were not made through L.M. Kohn and Vastano did not provide L.M. Kohn with prior written notice of his participation in the Alliance Leasing program. Vastano also did not receive written permission from the firm to sell the Alliance Leasing program. Most of the investors to whom Vastano sold Alliance Leasing units were L.M. Kohn customers. Some of these investors redeemed investments held at L.M. Kohn, including Individual Retirement Accounts, to obtain funds to invest in the Alliance Leasing program.

In addition to his own sales of the Alliance Leasing program, Vastano received a one-percent override on Alliance Leasing sales made by John Edwards ("Edwards"), another L.M. Kohn representative whom Vastano introduced to Morgan. In total, Edwards sold approximately $1.5 million of the Alliance Leasing program.[4] As a result of his sales of the Alliance Leasing program and the Edwards' override, Vastano received approximately $52,000 in commissions.

While he admits that he did not provide written notice to, or receive written permission from, L.M. Kohn to engage in sales of the Alliance Leasing program, Vastano testified that he did not believe that he needed to make such a disclosure because he originally learned of the program from Michael Yoakum ("Yoakum"), his supervisor at L.M. Kohn.[5] Yoakum denied that he introduced Vastano to the Alliance Leasing program and also denied that he recommended that Vastano sell the program.

Before the Hearing Panel, Vastano testified that Yoakum called him in May and brought the Alliance Leasing program to his attention. Vastano further testified that Yoakum stated that the Alliance Leasing investments were not securities, but were insurance products and advised Vastano to sell the product. According to Vastano, he believed that he could sell the product without notifying L.M. Kohn because he thought it was an insurance product.

Edwards, whom Yoakum also supervised, testified that he learned of the Alliance Leasing program from Yoakum. According to Edwards, in May 1998, Yoakum approached him and another Lighthouse Agency employee,[6] Mark Teague ("Teague"),

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[3] Among others, Vastano sold Alliance Leasing to his wife. Enforcement, however, did not charge Vastano with this sale.

[4] Edwards effected approximately 57 sales of Alliance Leasing investments.

[5] Yoakum ran an L.M. Kohn Office of Supervisory Jurisdiction in Ohio and was registered as an investment company products /variable contracts limited principal. Because of the distance between Yoakum in Ohio and Vastano in Massachusetts, most of their contact was by telephone. Yoakum also operates the Lighthouse Agency, an insurance agency.

[6] See supra note 5.

who was not licensed to sell securities, about the Alliance Leasing program, telling them "about this product that had a fixed rate of return, that was insured, that . . . was an insurance product." According to Edwards, Yoakum said that Teague could sell the product, even though he was not licensed to sell securities, and that Yoakum "was going to talk to Mr. Vastano about the product and that it was a good product that we should market."

Yoakum denied that he had any telephone conversation with Vastano about the Alliance Leasing program, but admitted that he discussed it with Edwards and Teague. According to Yoakum, he received an unsolicited brochure touting the Alliance Leasing program, merely mentioned it to Edwards and Teague (but not Vastano), and sent the brochure to Larry Kohn ("Kohn"), President of L.M. Kohn, who advised Yoakum that the firm's associated persons could not be involved in selling the program. There is no evidence that Yoakum was a master contractor, a managing contractor, or an independent sales contractor for purposes of selling Alliance Leasing investments, or that he ever participated in the sale of any Alliance Leasing investment in any capacity.

Vastano testified that he could have sold the product through Yoakum, but sold it though Morgan because Morgan offered him a larger commission. Vastano admits he never told Yoakum or L.M. Kohn that he was selling the Alliance Leasing investments through Morgan. Furthermore, Vastano completed and signed an L.M. Kohn Request to Engage in an Outside Activity form on May 30, 1998, 17 days after signing his Independent Sales Agreement with Morgan, but did not disclose in this form his involvement in selling Alliance Leasing products. Ultimately, L.M. Kohn learned of Edwards' sales when an L.M. Kohn customer called the firm while Edwards was on vacation. When the firm confronted Edwards, he admitted his participation and disclosed Vastano's involvement.

IV. Discussion

The Hearing Panel below found that Vastano participated in private securities transactions without giving his firm prior written notice of such activity or receiving permission to engage in the activity, in violation of Conduct Rules 2110 and 3040. After reviewing the record, we affirm the Hearing Panel's finding.

Conduct Rule 3040 prohibits any person associated with a member firm from "participat[ing] in any manner in a private securities transaction," unless, prior to participating in the transaction, the associated person provides "written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction." The rule defines a private securities transaction as "any securities transaction outside the regular course or scope of an associated person's employment with a member."

Conduct Rule 3040 also provides that if the associated person has received or may receive compensation for participating in a private securities transaction, the member firm must advise the associated person, in writing, whether the member approves or disapproves the person's participation. If the firm approves participation, it must record

the transaction on the firm's books and records and supervise the associated person's participation "as if the transaction were executed on behalf of the member." Finally, Conduct Rule 3040 provides that even if the person will not receive compensation, the firm may "require the person to adhere to specified conditions in connection with his participation in the transaction."[7]

Vastano does not contest any of the facts required to establish a violation of Conduct Rule 3040. First, we find that the transactions at issue are "private securities transactions." There is no dispute that the Alliance Leasing investments at issue are securities. In any event, we agree with the Hearing Panel and the District Court[8] that the Alliance Leasing investments were investment contracts, and, as a result, fall within the definition of a security.

Under SEC v. W.J. Howey Co., a product is an investment contract if (1) there is an investment of money, (2) in a common enterprise, (3) with the expectation of profits produced by the efforts of others. 328 U.S. 293, 298-99 (1946). Here, customers clearly invested money in the enterprise. We also find that there is a common enterprise because there is "horizontal commonality," a pooling of investor interests among investors, because Alliance Leasing pooled all investor funds into the Merrill Lynch account. Furthermore, we find that there is a common enterprise because there is "vertical commonality," namely that the fortunes of investors are linked with those of the promoters. As the District Court observed, the promoters were to receive a percentage of the net profits. Finally, investors relied on the efforts of Alliance Leasing to purchase and lease equipment for the purpose of generating the promised 28 percent return.

Although Vastano argues that he believed the Alliance Leasing investments were insurance products because the product was insured, his belief is not relevant to a finding of a violation of Conduct Rule 3040.[9] Conduct Rule 3040 requires an examination of whether the product was actually a security, not whether a registered person believed that the product was a security. For this reason, many firm compliance manuals, including L.M. Kohn's, require registered persons to disclose an outside business activity for approval if there is any chance that a product could be a security.[10]

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[7] A violation of Conduct Rule 3040 is also a violation of Conduct Rule 2110, which requires registered persons to adhere to the just and equitable principles of trade. See Steven J. Gluckman, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395 (July 20, 1999).

[8] See SEC v. Alliance Leasing Corp., 2000 U.S. Dist. LEXIS 5227, at *8-22 (S.D. Cal. 2000) (granting summary judgment), aff'd, 2002 U.S. App. LEXIS 153 (9th Cir. 2002) (unpublished decision).

[9] Vastano also argues that Rule 3040 does not apply because there were legal opinions that the product was not a security. We reject this argument because Vastano admits that he did not read or rely on these legal opinions.

[10] L.M. Kohn's compliance manual stated:

[Footnote continued on next page…]

We also agree with the Hearing Panel that the Alliance Leasing investments were outside the regular course and scope of Vastano's employment with L.M. Kohn. Vastano did not sell the Alliance Leasing investments through L.M. Kohn and the product was not on the firm's approved product list. The investments also were not supervised by L.M. Kohn or recorded on the firm's books and records. As such, Alliance Leasing investments were sales outside the regular course and scope of Vastano's employment with the firm. In fact, since Vastano was only a Series 6 representative, he would not have been properly registered to sell Alliance Leasing investments through the firm. We therefore find that Vastano's sales of Alliance Leasing investments constituted private securities transactions.

Vastano admits that he did not give written notice to L.M. Kohn that he wanted to participate in the sale of the Alliance Leasing program. Vastano also admits that he received compensation for his sale of Alliance Leasing investments. Since Vastano was receiving compensation for these securities transactions, he was required to receive written approval from L.M. Kohn prior to engaging in such transactions. Vastano, however, admits that he did not receive written permission from the firm to engage in such sales. Vastano therefore violated Conduct Rules 2110 and 3040.

Vastano argues that he did not violate Conduct Rule 3040 because he relied on verbal advice from Yoakum that the Alliance Leasing investments were not securities. This assertion, however, is not relevant for a finding of a violation of Conduct Rule 3040 because the rule requires written notice and written approval. See Dale M. Russell, 51 S.E.C. 561, 564 n.9 (1993) (finding that verbally notifying a member of an intention to engage in private securities transactions is inadequate). There is no exception for verbal statements by supervisors. Furthermore, Vastano's argument that L.M. Kohn and Yoakum should have discovered and stopped his sales of Alliance Leasing investments through better supervision also is not relevant. Vastano, as a registered person, is required to abide by NASD rules and cannot shift this burden to his superiors. See Gilbert M. Hair, 51 S.E.C. 374, 378 n.12 (1993).

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> [T]here are many cases where the determination of whether a particular investment product is or is not a security is very difficult. . . . . Registered Representatives are well advised not to rely on their own judgment. Even more dangerous is placing reliance on verbal representations made by product sponsors or a written opinion letter from a law firm. . . . Incorrect judgments on this question may subject the Registered Representative to . . . suspension or expulsion from the securities industry. . . . Our policy is that, if there is any possibility that an investment product may be a security, the Registered Representative must submit the product to the Compliance Department for review and approval prior to soliciting any sales of such product.

Vastano also argues that because he sold Alliance Leasing investments prior to October 1998, when he claims the SEC brought its complaint against Alliance Leasing, he did not violate Conduct Rule 3040. We find this argument to be without merit. Even if the SEC did not bring the action against Alliance Leasing, NASD may determine whether a product is a security and, as is the case here, find that a registered representative violated Conduct Rule 3040.

Vastano contends that if the Alliance Leasing program was not fraudulent, it may have succeeded. Vastano's argument has no bearing on the outcome of the case, however. A registered person's duties under Conduct Rule 3040 remain the same, regardless of whether the underlying product was fraudulent. Furthermore, the success of the underlying product is not relevant to a finding of violation of Conduct Rule 3040.

Based on a complete review of the record in this matter, we find that Vastano participated in private securities transactions, for compensation, without giving his firm prior written notice and without receiving written approval. Vastano therefore violated Conduct Rules 2110 and 3040.

V. Sanctions

For Vastano's violation of Conduct Rules 2110 and 3040, the Hearing Panel imposed a one-year suspension and a fine of $62,000. The NASD Sanction Guideline ("Guideline") for private securities transactions violations recommends that adjudicators impose a fine of $5,000 to $50,000 and a suspension of 10 days to one year or, in egregious cases, a longer suspension or a bar.[11] The Guideline also provides that "adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial benefit."[12]

The Guideline lists the following specific considerations in determining appropriate sanctions: (1) whether the respondent had a proprietary or beneficial interest in or was otherwise affiliated with the issuer; (2) whether the respondent attempted to create the impression that his employer sanctioned the activity; (3) whether the respondent sold away to customers of his employer; (4) whether the respondent gave his employer verbal notice of his participation; (5) whether the respondent sold the investment after he had been told or warned by his employer not to do so; (6) whether the respondent properly was registered 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.

The Hearing Panel found two factors mitigating: (1) Vastano did not have a proprietary or beneficial interest in Alliance Leasing; and (2) there was no evidence that

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[11] See Guideline, (Selling Away - Private Securities Transactions) (2001 ed.) at 19-20.

[12] Id. at 19 n.2.

Vastano attempted to create the impression that his firm sanctioned the sales of Alliance Leasing investments. We disagree with the Hearing Panel that these two considerations are mitigating in this case; rather, we find that these two factors typically only aggravate an associated person's conduct. Furthermore, we find numerous aggravating facts. Vastano sold away to customers of L.M. Kohn, and, as a Series 6 representative, Vastano was not properly registered to sell Alliance Leasing investments. Vastano also failed to give his firm oral notice of his participation in the program.

Vastano's misconduct caused some L.M. Kohn customers to invest not only in an unapproved product, but also in a fraudulent Ponzi scheme. As the SEC has stated on numerous occasions, "Rule 3040 is designed not only to protect investors from unmonitored sales, but also to protect securities firms from exposure to loss and litigation in connection with sales made by persons associated with them." Jim Newcomb, Exchange Act Rel. No. 44945, 2001 SEC LEXIS 2172, at *19 (Oct. 18, 2001). Indeed, Vastano prevented his firm from examining the Alliance Leasing program and determining, through due diligence, whether to endorse or deny its offer and sale. Vastano ignored the clearly written provision in the firm's compliance manual that prohibited employees from engaging in private securities transactions without submitting the product to L.M. Kohn's Compliance Department for review and approval prior to soliciting sales of the product. Vastano also disregarded the firm's policy of prohibiting the sale of investments that were not on an approved product list.

Moreover, one of 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."[13] Here, Alliance Leasing collapsed under the weight of the Ponzi scheme, which resulted in the company filing for bankruptcy. Vastano's customers who invested in Alliance Leasing suffered significant losses. As a result of these aggravating factors and the lack of mitigating factors, we find that Vastano's misconduct is serious and warrants substantial sanctions.

Vastano points out alleged inconsistencies between the hearing testimony of Kohn and Yoakum and their individual investigative testimony previously taken by NASD staff. While we note that there may be minor inconsistencies, we do not find that these minor inconsistencies lead to the conclusion that either of their testimonies was untruthful. In fact, many of the alleged inconsistencies that Vastano points out were actually consistent when read in context or were the result of Vastano's mischaracterizations of testimony.[14] We also find that there was no financial incentive

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[13] See Guideline (Principal Considerations in Determining Sanctions) (2001 ed.) at 10.

[14] For example, Vastano argues that Kohn stated in his investigative testimony in 2000 that he knew of the Alliance Leasing program, but that Kohn gave conflicting hearing testimony in 2002 by denying that he knew or approved of Alliance Leasing as an insurance product. In proper context, Kohn testified in 2000 and 2002 that he learned of Alliance Leasing from Carl Hollister, a firm executive vice-president, in 1999. This

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for Yoakum or the firm to allow Vastano to engage in sales of Alliance Leasing investments because Yoakum or the firm did not receive compensation for the transactions.[15] Vastano argues that Yoakum wanted him to sell the Alliance Leasing product through Yoakum's insurance company and that would have been his financial incentive. Yoakum, however, was not an Alliance Leasing master contractor, managing contractor, or independent sales contractor. Neither Yoakum nor the firm therefore could have received any compensation from Alliance Leasing. We agree with the Hearing Panel, moreover, that Vastano's testimony during the hearing was not credible. In fact, at one point during the hearing, Vastano gave clearly false testimony.[16]

Vastano contends that he reasonably believed that the Alliance Leasing investments were not securities. In support, Vastano argues that he believed that they were insurance products because Alliance Leasing represented, through promotional materials, that the product was insured. We find this belief neither reasonable nor plausible.[17] As an investment company products/variable contracts limited representative, one of the products that Vastano could sell was variable annuities, which many times contain an insurance component, but have long been classified as securities. Furthermore, it was not reasonable for him to assume that an insured product is never a security.

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was after Vastano and Edwards sold the product in 1998. Kohn never testified that he approved the product. Kohn also never stated that the product was an insurance product.

[15] Vastano's counsel stated in his brief and during oral argument before the NAC Subcommittee that Vastano had clients redeem mutual fund shares to purchase Alliance Leasing investments. As such, Yoakum may have actually lost money because of lost trailer commissions associated with those mutual funds.

[16] On December 10, 1999, Vastano responded, in writing, to a series of NASD staff questions about his involvement in the sale of Alliance Leasing investments. This letter was almost word-for-word identical to Edwards' December 2, 1999 letter, which responded to a similar inquiry about his involvement. At the hearing, before Enforcement showed him Edwards' letter, Vastano testified that he had written his letter in his own words, that he had not spoken to Edwards about the letter, and that he had not received a copy of Edwards' letter prior to writing his letter. We agree with the Hearing Panel that this testimony was clearly false.

[17] Furthermore, Vastano signed his Independent Sales Agreement on May 13, 1998 and made his first sale of the product on June 4, 1998. Alliance Leasing, however, did not enter into an agreement to insure the product until June 16, 1998, and Vastano was not officially notified of this agreement until July 9, 1998. Moreover, the contract for the June 4, 1998 sale did not contain any statement about the product being insured. Vastano is therefore arguing that he believed that the product was an insurance product based on insurance that did not exist at the time he contracted to sell the product or at the time that he actually made his first sale.

Vastano also states that his wife's investment in the program should mitigate his conduct. This purchase, however, only shows that he believed in the Alliance Leasing program and has no impact on his duty to seek and receive approval from his firm to sell Alliance Leasing investments to the Firm's customers.

Vastano also argues that he relied on oral statements by Yoakum that the product was not a security and that he could sell the product. In support of this contention, Vastano offered the affidavit and testimony of his secretary in which she stated that, after receiving a phone call from Yoakum, Vastano came out of his office and was excited that he would be able to sell Alliance Leasing investments. Even if we were to accept Vastano's representation of events, it would not aid him. Vastano testified that at the time he sold Alliance Leasing investments, he knew of an instance where L.M. Kohn notified its registered representatives that they were not permitted to sell non-traditional investments. Specifically, Vastano claimed that he learned that Yoakum had approved the sale of viatical investments, but L.M. Kohn later notified all firm representatives that they were not permitted to sell such investments. Vastano therefore knew that Yoakum could not approve the sale of non-traditional investments, such as Alliance Leasing.

Because of the seriousness of his misconduct and the numerous aggravating factors, we increase Vastano's suspension to 18 months, but affirm the $62,000 fine as properly remedial.[18] We also order Vastano to pay hearing costs for the proceeding below, appeal costs, and an appeal hearing transcript fee of $380.86.[19]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

[18] Of the $62,000 fine, $10,000 represents the fine and $52,000 represents the amount in commissions that Vastano received from his sales of the Alliance Leasing investments and the Edwards' override.

[19] We also have considered and reject without discussion all other arguments advanced by the respondent.

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