BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of Department of Enforcement, Complainant, vs. Joseph Gaetano Gerace West Indies, Respondent.	DECISION Complaint No. C02990022 Dated: May 16, 2001

Hearing Panel held the chief operating officer responsible for his firm's failure to establish an escrow account when conducting a contingency offering and its failure to refund investors' funds when it did not sell the required amount of securities to bona fide purchasers. Held, findings affirmed and sanctions affirmed.

Joseph G. Gerace ("Gerace") has appealed an August 28, 2000 hearing panel ("Hearing Panel") decision pursuant to Procedural Rule 9311. After a review of the entire record in this matter, we affirm the findings of the Hearing Panel that Gerace failed to have his firm establish an escrow account when it conducted a contingency offering and failed to have his firm refund investors' funds when it did not sell the minimum amount of securities to bona fide purchasers by the offering's closing date. We find that Gerace violated Exchange Act Rules 15c2-4 and 10b-9 and Conduct Rule 2110. We affirm the Hearing Panel's sanctions of a $10,000 fine and a one-year suspension as a securities principal.

Background

Gerace entered the securities industry in 1981. From April 1996 through February 1997, Gerace was associated with Interfirst Capital Corporation ("Interfirst" or the "Firm")[1] as a general securities principal. Gerace is not currently employed in the securities industry.

[1] Although Interfirst was previously known as Baraban Securities, Inc., for the sake of simplicity this decision will refer to the Firm as Interfirst. The Firm changed its name to Interfirst in December 1996.

This case involves Interfirst's handling of a private placement of senior subordinated notes of a real estate company.[2] The real estate company, American Realty Trust, Inc. ("ART"), invested in equity interests in real estate, leases, and joint venture development projects, and financed real estate.

Discussion

The majority of the facts in this case are not in dispute. We review in detail the facts regarding the ART private placement because we have considered all of this information in deciding upon the sanctions that we impose on Gerace. In proceedings before the Hearing Panel, Gerace admitted that Interfirst violated Exchange Act Rules 15c2-4 and 10b-9, but he denied that he was responsible for the Firm's violations.[3] Gerace argued that the owner of Interfirst, Bradford Phillips, and his father, Gene Phillips, were responsible for the violations.

Corporate Takeover of Interfirst Capital Corporation. In early 1996, Interfirst was a broker-dealer headquartered in Los Angeles with 11 California offices and approximately 700 registered representatives. Bradford Phillips was a real estate professional located in Dallas, Texas. In April 1996, Bradford Phillips completed a hostile takeover of Interfirst by purchasing a majority of the Firm's common stock.[4] When he took over Interfirst, Bradford Phillips did not have any NASD registrations, and he had never been a general securities principal.

One day before Bradford Phillips acquired control of Interfirst, on April 3, 1996, he and Gerace agreed that Gerace would serve as chief operating officer ("COO") of Interfirst. When Bradford Phillips took over Interfirst, he represented in a letter to the NASD that he would not participate in the securities business of Interfirst until he obtained the proper registrations. In June 1996, Bradford Phillips passed the NASD's Series 7 and 24 qualifications exams. Although Bradford Phillips obtained these registrations, Gerace's duties as the COO did not change. Bradford Phillips was not involved in the day-to-day operations of the Firm, and he continued to work from his office in Dallas.

The American Realty Trust Offering. In May 1996, Bradford Phillips discussed with Gerace Interfirst's acting as agent for a private debt offering for ART, a New York Stock Exchange-listed company. The day-to-day real estate operations of ART were managed by Basic Capital

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[2] Interfirst settled this matter with NASD Regulation's Department of Enforcement ("Enforcement") before a complaint was filed. Interfirst agreed to an Acceptance, Waiver, and Consent in which it was fined $10,000 and ordered to offer rescission to all investors.

[3] A routine NASD Regulation examination of Interfirst led to an investigation and Enforcement's complaint in this matter.

[4] Bradford Phillips used MHK Investment Corporation, an entity wholly owned by him, to acquire control of Interfirst.

Management, Inc. Basic Capital Management was owned by a trust created for the benefit of the children of Gene Phillips.[5]

Bradford Phillips and Gerace agreed that Interfirst would act as agent for the ART private placement. Gerace communicated with the Firm's sales force to develop an interest in the offering.

In June 1996, Gerace hired Douglas Wright ("Wright") as Interfirst's compliance officer. When Wright accepted the position, he told Gerace that he had no prior experience in private offerings and he could not come up to speed fast enough to advise the Firm on any regulatory problems that might exist in the proposed ART offering. In response to Wright's concerns, Gerace explained that he would handle the ART offering.

On August 26, 1996, Gerace signed, as Interfirst's COO, a Private Placement Agency and Dealer Manager Agreement ("Private Placement Agreement") with ART. Pursuant to the Private Placement Agreement, Interfirst agreed to sell, on a "best efforts" basis, ART's 11 ½ percent senior subordinated notes. Interfirst would offer the securities subject to a minimum sales requirement of $1,000,000 and a maximum of $5,000,000.

Beginning August 26, 1996, Interfirst offered and sold the ART notes in reliance upon Regulation D exemptions from the registration requirements of the Securities Act of 1933 and the applicable state blue sky statutes. Interfirst sold the securities only to "accredited investors" in increments of $10,000.[6] Investors in the offering were to deliver completed subscription forms and checks to Interfirst by September 30, 1996.

Lack of an Escrow Account. Interfirst did not set up a bank escrow account or use a bank trust account to hold investors' funds pending the closing of the offering. The Private Placement Agreement stated that no arrangements had been made for placing funds received in any special account with a national bank or in a bank escrow account.[7] The decision that the Firm need not establish an escrow account was made on the legal advice of an outside attorney representing ART. Consequently, the investors' subscription checks were made payable to "American Realty Trust, Inc.," and Interfirst sent them immediately to the issuer, ART.

Shortly after Interfirst started selling the offering, about September 3, 1996, an Interfirst employee told Wright that an escrow account had not been established for the ART offering and, in the employee's view, the rules required such an account. Wright relayed this concern to Gerace.

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[5] Bradford Phillips' brother and uncle were members of the board of directors of Basic Capital Management. On August 16, 1996, Basic Capital Management owned approximately 38 percent of the outstanding shares of ART.

[6] See Securities Act Rule 501(a).

[7] For the discussion that follows, we will use the term "escrow account" as shorthand for both a separate trust account with a bank or a bank escrow account.

Gerace, in turn, spoke with ART's lawyer, who repeated his previous opinion that no escrow account was needed. Gerace made no further inquiries about the need for an escrow account.

Davister Corporation's Investment in the ART Offering. During September 1996, Bradford Phillips concluded that investors were not as interested in the ART offering as the Firm had projected. After Interfirst had received more than $600,000 in commitments to purchase ART notes, Bradford Phillips told Gerace that he knew of a company in Dallas, Davister Corporation, that would purchase enough of the offering to meet the $1,000,000 minimum.

Gerace was familiar with Davister Corporation because he had signed its Interfirst account form as its registered representative on July 16, 1996. Davister Corporation's mailing address was 10690 North Central Express, Suite 640, in Dallas. ART had the same address but was located in Suite 300. Furthermore, according to ART's Form 10K for the period ended December 31, 1995, as of March 15, 1996, Davister Corporation owned approximately 14.2 percent of ART's common stock through Nanook Partners, L.P.

Bradford Phillips asked ART's attorney to address the issue of whether Davister Corporation would qualify as a bona fide purchaser in the ART offering. The attorney advised Bradford Phillips and Gerace that Davister Corporation was not a related party because it was a non-managing general partner of a partnership that owned more than 10 percent of ART's common stock.

On September 27, 1996, Davister Corporation completed subscription forms for the ART offering and wrote two checks for a total of $390,000. By September 30, 1996, ART had received subscriptions totaling $1,020,000, including Davister Corporation's subscription. ART decided that the $1,000,000 minimum subscription amount was met and it closed the private placement on September 30, 1996. ART then deposited into its bank account the investors' checks that it had previously received from Interfirst.

Violation of Rule 15c2-4. Exchange Act Rule 15c2-4 provides that a broker or dealer who participates in a contingent offering and accepts the sales price of a security before all the represented contingencies are met must either deposit the investors' funds into "a separate bank account, as agent or trustee for the persons who have the beneficial interests therein" or transmit the investors' funds to a bank that has "agreed in writing to hold all such funds in escrow." If a broker or dealer fails to handle the investors' funds in the prescribed manner, the broker or dealer has committed a fraudulent, deceptive or manipulative act or practice. Exchange Act Rule 15c2-4.

Interfirst violated Exchange Act Rule 15c2-4 when it failed to establish a bank escrow account or a bank trust account for receipt of the investors' funds pending the satisfaction of the contingency. There is no dispute that the investors' funds were sent directly to ART and that they were held by ART until September 30, 1996.

We affirm the Hearing Panel's finding that Gerace was responsible for the Firm's violation of Exchange Act Rule 15c2-4 and Conduct Rule 2110.[8] Gerace was COO of Interfirst during the entire ART private placement. When Gerace hired Wright as the Firm's compliance officer, Gerace retained responsibility for conducting the ART offering. In an August 29, 1996 letter from Wright to the NASD, Wright stated that any questions regarding the ART offering should be directed to Gerace. Gerace was copied on this letter. The witnesses consistently testified that Gerace was in charge of the private placement.

On appeal, Gerace argues that, because he reasonably relied on ART's attorney's legal advice, he is being unfairly held responsible for Interfirst's violations of SEC and NASD rules. Gerace also emphasizes that the impressive real estate experience of Basic Capital Management, Bradford Phillips, and Gene Phillips led him to believe that ART was complying with all applicable SEC rules during the private placement.

We agree with the Hearing Panel's conclusion that Gerace should be held responsible for the violations that he allowed to occur. Gerace was aware or should have been aware that the investors' funds would not be in a bank escrow account because he signed the Private Placement Agreement that described this arrangement. Gerace failed to consult an outside attorney for Interfirst on this issue, even though Interfirst had used outside counsel previously. Gerace did not ask NASD Regulation staff whether an escrow account was required for the offering. As a general securities principal in the securities profession, Gerace had a duty to ensure that he understood the rules governing a broker-dealer's conduct when participating in a contingent offering. Particularly in light of the fact that an employee of the Firm asked Gerace about the lack of an escrow account, Gerace's failure to seek guidance from an independent expert was reckless. We hold Gerace responsible for his failure to carry out his duty.

As to Gerace's defense that he relied on the advice of counsel, this defense is not available for a violation of Exchange Act Rule 15c2-4 because Section 15(c)(2) of the Exchange Act -- the authority for issuing Rule 15c2-4 -- does not require scienter. See Market Regulation Comm. v. J.C. Bradford & Co., 1999 NASD Discip. LEXIS 25 at *13 (NAC June 10, 1999) (no scienter requirement for a rule promulgated under Section 15(c)(2)).[9]

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[8] Conduct Rule 2110 is applicable to an associated person pursuant to Rule 115(a), which states that "[t]hese Rules shall apply to all members and persons associated with a member. Persons associated with a member shall have the same duties an obligations as a member under these Rules."

[9] Moreover, Gerace failed to satisfy the requirements of this defense. A respondent must show that he: (1) made a complete disclosure to an attorney of the intended action; (2) requested the attorney's advice on the legality of the intended action; (3) received counsel's advice that the conduct would be legal; and (4) relied in good faith on the advice. See William H. Gerhauser, Exchange Act Rel. No. 40639, at 12 n.26 (Nov. 4, 1998). Here, Gerace could not have relied in good faith on the legal advice because the lawyer was ART's attorney, not Interfirst's.

We also reject Gerace's claim that Bradford Phillips or Gene Phillips should be disciplined for the Firm's violations because they were the "real power" behind Interfirst. The fact that one person, or one family, may be the owner of a broker-dealer is not a sufficient reason, in and of itself, for the owner to be held responsible for the firm's violations of securities regulations in an NASD disciplinary action. Here, Gerace was both the COO and the principal in charge of the ART offering. Gerace made the decisions for the Firm about how to conduct the ART offering. Although Bradford Phillips was registered as a general securities principal during the offering, we agree with the Hearing Panel's assessment that he was not handling any part of the Firm's participation in the ART offering. As to Gene Phillips, we find no evidence in the record indicating that he was responsible for any of Interfirst's misconduct in this matter. In short, we view Gerace's arguments about the Phillipses as an unsuccessful attempt to shift responsibility away from himself.

Failure to Satisfy the Minimum Sales Contingency. Exchange Act Rule 10b-9 prohibits any person from making a representation that a security is being offered on an "all-or-none" basis unless the amount due from the investor is to be refunded if all of the securities being offered are not sold or the seller does not receive the total amount due by a specific date.[10]

A minimum contingency offering may not be considered sold for purposes of the representation unless the securities are sold in bona fide transactions and the purchase prices are fully paid.[11] See Requirement of Rules 10b-9 and 15c2-4 Under the Securities Exchange Act of 1934 Relating to Issuers, Underwriters and Broker-Dealers Engaged in an "All or None" Offering, Exchange Act Rel. No. 11532 (July 11, 1975). If an entity with a significant stake in the success of a contingency offering makes undisclosed purchases of securities in order to meet the contingency and close the offering, the facade of a successful offering is created and the representation that the offering will meet a certain minimum contingency is rendered false.

Here, Davister Corporation owned 14.2 percent of ART and therefore had a significant stake in the success of the private placement. Davister Corporation was not a bona fide investor because it was an affiliate of ART.[12] As the SEC has explained, one purpose of Rule 10b-9 is to require the minimum sales contingency to be satisfied by purchasers who are independent of the issuer. "[F]or the purpose of the 'all or none' or 'part or none' condition" it is contrary to the purpose of the rule to declare an offering sold "on the basis of non-bona fide sales designed to create the appearance of a successful completion of the offering, such as purchases by the issuer through nominee accounts or purchases by persons whom the issuer has agreed to guarantee against loss." Id.

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[10] See Louis Loss and Joel Seligman, Securities Regulation Vol. VIII at 3893 (3d ed. 1991).

[11] We also find that Interfirst violated Rule 10b-9 because purchases of $1,000,000 had not been paid by the September 30, 1996 closing. The two checks totaling $390,000 from Davister Corporation were not deposited into ART's checking account until October 31, 1996.

[12] Cf. C.E. Carlson, Inc. v. SEC, 859 F.2d 1429, 1432 n.3, 1434 (10th Cir. 1988).

We affirm the Hearing Panel's finding that Gerace was responsible for the Firm's violation of Rule 10b-9. Gerace was in charge of the ART private offering. He knew that there was a question as to whether the $1,000,000 sales contingency had been met because of Davister Corporation's affiliation with ART. In addition, Gerace knew or should have known of the connections between ART and Davister Corporation. In July 1996, when Gerace signed up Davister Corporation as a customer of the Firm, one of the two principal officers listed on the new account form was identified as the Treasurer of Davister Corporation. In the private placement memorandum for the ART offering, the same person is identified as the Treasurer of ART. Moreover, ART and Davister Corporation were located in the same building in Dallas. Therefore, we hold Gerace responsible for allowing Interfirst to agree to the closing of the ART offering when a non-bona fide purchaser had purchased a large percentage of the offering.

Gerace again argues that he relied on the advice of counsel as to whether Davister Corporation was a bona fide purchaser. We reject this argument based on one of the reasons that we previously discussed, namely that ART's attorney was not Interfirst's attorney. Supra, footnote 11. We also reject Gerace's argument about the Phillipses for the same reasons that we previously enumerated.

We agree with the SEC's statement regarding the importance of Rule 10b-9: "Violations of Rule 10b-9 and 15c2-4 are serious breaches of the duty owed by issuers, underwriters and broker-dealers to the investing public." Exchange Act Rel. No. 11532 (July 11, 1975). The SEC noted the gravity of a violation of Rule 10b-9 when, "the facade of a successful offering is created in derogation of responsibilities owed to public investors who have purchased securities which were offered with the representation that their funds would be returned if the contingency were not fully satisfied." Id. Gerace allowed such a breach to occur in this case. Given the non-bona fide purchases by Davister Corporation, the investors should have had their funds returned.

We conclude that Gerace violated Exchange Act Rules 15c2-4 and 10b-9 and Conduct Rule 2110.[13]

Procedural Matters

Gerace included several new exhibits (numbered one through nine) with his opening brief to the NAC. We deem his inclusion of these documents, which were not in the record, to be a motion to adduce additional evidence. We deny this motion and order that the new exhibits be excluded from the record.

Procedural Rule 9346(b) requires that parties seeking to introduce new evidence satisfy the burden of demonstrating that: (1) there was good cause for failing to introduce the evidence before the Hearing Panel; and (2) the evidence is material to the proceeding. Gerace explains that he

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[13] Violations of Exchange Act Rules 15c2-4 and 10b-9 constitute a violation of Conduct Rule 2110. See Norman E. Mains, 1997 NASD Discip. LEXIS 3 at *21 (NBCC Jan. 3, 1997).

wishes to adduce the new evidence to illustrate the size, experience, and scope of Basic Capital Management.

We find that the new documents are not material. The existing evidence in the record describes Basic Capital Management and its role as contractual advisor to ART. Gerace's proposed new evidence is cumulative and is therefore not material. Gerace also has not demonstrated good cause for failing to introduce this evidence before the Hearing Panel. Moreover, Gerace failed to comply with the deadline for making a motion to adduce additional evidence on appeal. See Procedural Rule 9346(b).

Sanctions

The Hearing Panel imposed sanctions of a $10,000 fine and a one-year suspension in all principal capacities. These sanctions are consistent with the NASD Sanction Guidelines.[14]

Gerace has a disciplinary history that involves two prior regulatory actions. In June 1991 Gerace consented to a finding by the American Stock Exchange that he executed options transactions in a customer's account that were unsuitable, and that he used discretion in a customer's account without obtaining written authorization or prior approval of a registered options principal. Gerace agreed to a censure and a fine of $10,000. More significantly, in October 1997 Gerace consented to the NASD's entry of findings that he directed sales representatives to pre-sell common stock without a final registration statement's being effective, in violation of Section 5 of the Securities Act and NASD rules. Gerace was censured, fined $5,175 and ordered to requalify as a general securities principal. We consider this disciplinary history to be relevant to our evaluation of the level of sanctions for this case. Accordingly, we follow the Guidelines' concept of imposing "progressively escalating sanctions" in order to deter future misconduct.

The specific considerations listed in the Guideline relevant to Gerace's misconduct are: (1) the extent of the failure to satisfy the contingency described in the private placement memorandum, and (2) whether the respondent used non-bona fide sales to give the false appearance that the contingency was satisfied. Here, the Davister Corporation purchases were almost one-third of the ART offering, a large portion of the minimum sales amount. Because the offering fell significantly short of the contingency, Gerace's failure to seek legal advice from a lawyer for the Firm as to whether the Davister Corporation purchase was a bona fide purchase showed a reckless attitude toward compliance with Rule 10b-9. As to the second Guideline consideration, Gerace allowed non-bona fide sales to give the appearance that the contingency was satisfied.

Turning to the general principles contained in the Guidelines, we consider the following facts to be significant: First, Gerace has refused to accept responsibility for his central role in the Firm's violations of the SEC and NASD rules. Instead, Gerace seeks to shift the blame to other

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[14] See NASD Sanction Guidelines ("Guidelines") (1998 ed.) at 21 (Escrow Violations - Prohibited Representations In Contingency Offerings; Transmission Or Maintenance Of Customer Funds In Underwritings).

individuals.[15] Second, we find that although Gerace did not act intentionally in causing his Firm to engage in misconduct, he acted recklessly. At the time of the ART offering, Gerace had been in the securities business for 18 years. He had been a general securities principal for eight years and had previously served as a managing director of another NASD member. Given his level of experience, we fault Gerace heavily for his failure to take additional steps to comply with the rules governing the conduct of a private placement.[16] Third, we have considered whether Gerace demonstrated reasonable reliance on competent legal advice.[17] Although we accept that Gerace believed that ART's lawyer was competent, we find that the attorney's representation of the issuer, and not Interfirst, and the warning that an employee of Gerace's own Firm gave him regarding an escrow account, negate any mitigation that we would have given to Gerace for relying on the attorney's advice.

For violations of Exchange Act Rule 15c2-4 and Conduct Rule 2110, the Guidelines recommend a fine between $1,000 and $10,000 and suspension in any or all capacities for up to 30 business days in egregious cases. For violations of Exchange Act Rule 10b-9 and Conduct Rule 2110, the Guidelines recommend a fine between $5,000 and $50,000 and a suspension in any or all capacities for up to two years in egregious cases.

Based on the aggravating factors that we discussed above, we conclude that Gerace's actions were an egregious violation of Exchange Act Rules 15c2-4 and 10b-9. We agree with the Hearing Panel in this regard. Like the Hearing Panel, we limit the suspension of Gerace to a principal capacity because his misconduct was grounded in his failure to carry out properly his duties as a principal.

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15 See Principal Consideration number two of the Guidelines, p. 8.

16 Id. at 9 (principal consideration 13).

17 Id. at 8 (principal consideration 7).

Accordingly, Gerace is fined $10,000 and suspended in all principal capacities for one year.[18]

On Behalf of the National Adjudicatory Council,

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Barbara Sweeney
Senior Vice President and Corporate Secretary

[18] 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 Procedure Rule 8320, any member who 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 sanctions, after seven day's notice in writing, will summarily be revoked for non-payment.