BEFORE THE NATIONAL ADJUDICATORY COUNCIL
NASD REGULATION, INC.

In the Matter of Department of Enforcement, Complainant, v. Aleksandr Shvarts Brooklyn, New York, Respondent	DECISION Complaint No. CAF980029 Dated: June 2, 2000

Where Hearing Panel had dismissed complaint alleging individual's failure to pay attorney fees and costs awarded in court proceedings associated with customer-initiated arbitration, held, Hearing Panel decision reversed, violation of Conduct Rule 2110 found, and respondent fined, suspended, and ordered to pay court award.

The NASD Regulation, Inc. ("NASD Regulation") Department of Enforcement ("Enforcement") appealed this matter after an NASD Regulation Hearing Panel issued an April 29, 1999 decision dismissing the complaint's allegations that respondent Aleksandr Shvarts ("Shvarts") had violated Conduct Rule 2110.

We hold that Shvarts violated Conduct Rule 2110 by failing to comply with a court judgment awarding to his former customers the attorney fees and costs they incurred in litigation that he filed against them challenging an arbitration award they had won from him. We order that Shvarts be fined $5,000, suspended for six months, and required to pay the customers the fees and costs awarded to them. If he does not submit satisfactory proof of this payment to NASD Regulation staff within 60 days of the date of this decision, he shall be barred.

Background

Aleksandr Shvarts. Shvarts entered the securities industry in 1987 as a registered representative.[1] He was the president and primary owner of former NASD member firm American Bond Group, Inc. ("American Bond"), and he was registered with it as a general securities representative, general securities principal, and FINOP between 1990 and 1993.

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[1] Sharvts was registered, originally as a general securities representative and later as a general securities principal, financial and operations principal ("FINOP"), and/or options principal, with various firms between 1987 and December 1998.

Shvarts has not been registered with any member firm in any capacity since December 1998.[2] In addition, on June 17, 1999, the NASD revoked his registration for nonpayment of fines and costs associated with another disciplinary action.

The Arbitration Proceedings. Shvarts' misconduct relates to his failure to pay an award of fees ordered in litigation related to an arbitration. The undisputed facts about the litigation are as follows:

In February 1993, customers AO and LO, a married couple (collectively, "the O's"), filed an NASD arbitration claim against American Bond and Shvarts alleging misconduct in connection with their account.[3] American Bond and Shvarts did not answer the statement of claim or appear at the arbitration hearing, which was held in November 1993. On February 3, 1994, an arbitration panel issued an award (the "1994 Award") requiring American Bond and Shvarts, jointly and severally, to pay the customers $33,004.89 plus pre-judgment interest, $15,000 in punitive damages, $2,000 in costs, and $400 in forum fees.

On November 17, 1994, American Bond and Shvarts filed a complaint against the O's in the Circuit Court for the 17th Judicial Circuit in and for Broward County, Florida (the "Florida Trial Court")

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We have jurisdiction over Shvarts in this matter because the complaint, which was issued on August 7, 1998, was issued while he was registered as an associated person with another member firm.

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According to the arbitrators' February 3, 1994 decision:

> Claimants alleged that . . . Shvarts, desperate to protect his failing business and his multi-million-dollar position in the class A warrants of Fonic, Inc. [(]"Fonic") aggressively and deceptively pushed the sale of Fonic's stock, even to specifically inappropriate accounts such as Claimants [sic], and then used every trick possible to delay or avoid those shares ever coming back onto the market to reduce the value of his warrants. Claimants further alleged that the foregoing pattern of chicanery effectively transferred the normal choice of "buy, sell, or hold" from the Claimants to [Shvarts and American Bond], who became, for all practical purposes, the De Facto owners of the shares of which Claimants were merely the legal owners. Claimants contended that [Shvarts' and American Bonds'] rigorous policy of blocking the sale of Claimants' 4,300 shares of Fonic, even when its value was $60,000, together with other deceptive, and probably fraudulent practices have caused Claimants substantial financial losses.

According to representations made by the attorney for the O's in correspondence adduced by Shvarts, the O's are both over 80 years of age.

seeking an order vacating the 1994 Award on the grounds that Shvarts had never received proper notice of the arbitration hearing.[4] Shvarts asserted that he had been hospitalized at the time of the arbitration hearing, that he first learned of the arbitration proceedings in July 1994, and that the NASD had lost the relevant arbitration case file.

In July 1995, the Florida Trial Court remanded the matter to the NASD arbitration panel that had presided over the arbitration proceeding to issue a ruling stating whether the notice requirement of the arbitration rules were met prior to the entry of the 1994 Award. In October 1995, the Florida Trial Court granted a motion for rehearing filed by American Bond and Shvarts and issued an amended remand order with instructions to the arbitration panel to hold an evidentiary hearing to determine whether American Bond and Shvarts had received proper notice under the NASD Rules and an opportunity to be heard prior to the entry of the 1994 Award.

In January 1996, the arbitration panel that had issued the 1994 Award held a day-long evidentiary hearing. In a ruling dated March 14, 1996, the panel noted that it had heard testimony from two NASD administrators and had reviewed a partially reconstructed file and NASD computer records. The panel held that American Bond and Shvarts had received proper notice of the arbitration claim pursuant to Section 25 of the Code of Arbitration Procedure, because the statement of claim -- as well as numerous other documents -- had been sent to them at American Bond's business address between February and June of 1993 and the NASD had not received any information indicating that the mailings were not received.[5]

On March 25, 1996, the Florida Trial Court, in a final judgment, confirmed the 1994 Award -- which then totaled $60,549.47 with interest -- but retained jurisdiction to assess attorney fees and costs.

American Bond and Shvarts appealed. On April 23, 1997, a Florida appeals court affirmed the confirmation order and ruled that the O's were entitled to recover from Shvarts and American Bond the attorney fees and costs that they incurred on appeal. On November 24, 1997, the Florida Trial Court

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Throughout the Florida court proceedings, Shvarts was represented by Florida counsel.

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The panel also noted that although American Bond had ceased business operations in the Summer of 1993, neither American Bond nor Shvarts had notified the NASD of a change of address. The panel held that under these circumstances, the NASD had not been obligated to attempt to send the statement of claim to Shvarts at his home address. The panel also noted that James Monteleone ("Monteleone"), a registered representative who had handled the claimants' account at American Bond, had testified that Shvarts was aware of the arbitration during the Spring of 1993. Finally, the panel noted that Shvarts alleged that documents establishing his hospitalization for treatment and counseling had been sent to the NASD in November 1993 (apparently, according to Shvarts' brief filed with the NAC, because the NASD was then seeking to schedule an interview with Shvarts). The panel held, however, that it had not been obligated to continue the arbitration hearing because no request for a continuance had been submitted and the panel itself had been unaware of the hospitalization.

issued a final judgment awarding the O's $47,651.12, plus interest to accrue at 10 percent per year, for the attorney fees and costs they had incurred at both the appellate and trial levels.

The Florida appeals court's April 23, 1997 order is not in the record, and the Florida Trial Court's November 24, 1997 judgment did not explain the rationale for awarding attorney fees and costs against American Bond and Shvarts, but the parties have stipulated that fees and costs were assessed pursuant to Section 57.105 of the Florida statutes. Section 57.105 authorizes a court to require a losing party and/or his attorney to pay the reasonable attorney fees of the prevailing party upon a finding that the losing party did not raise a "justiciable issue of either law or fact."[6]

In May 1997, Shvarts paid the O's the 1994 Award, with interest. To date, however, neither Shvarts nor American Bond has complied with the court's order requiring them to pay the O's their attorney fees and costs.

<u>The NASD Disciplinary Complaint and Answer.</u> On August 7, 1998, Enforcement filed a disciplinary complaint alleging that Shvarts had violated Conduct Rule 2110 by failing to pay the attorney fees and costs despite numerous requests for payment.[7]

Shvarts, through counsel, filed an answer admitting that he had failed to pay the court-ordered attorney fees and costs but asserting defenses. Among other things, Shvarts asserted that the complaint failed to state a claim upon which relief could granted; that the conduct charged did not "involve conduct of [Shvarts'] business" within the scope of the NASD's jurisdiction; and that the NASD was improperly attempting to enforce new rules without the consent of the Securities and Exchange Commission ("SEC") and in violation of the standards of equal protection and due process.[8]

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The Florida trial court awarded attorney fees against Shvarts, but not his counsel.

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Enforcement's filing of the complaint occurred after an attorney representing the O's contacted the NASD to complain about Shvarts' non-payment of the award of attorney fees and the NASD's conduct in this matter.

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On December 7, 1998, Shvarts filed an amended answer to correct a minor error in his original answer. Shvarts also sought to amend his answer to include an additional defense alleging that the NASD had "proximately caused" at least a portion of the attorney fee expense. Shvarts claimed in the proposed additional defense that some portion of the fees were a result of the court's decision to remand the matter to the NASD arbitration panel for an evidentiary hearing on the question of notice, and that the remand was necessary because the NASD had lost critical portions of the arbitration file and had failed to include, in the arbitration award, a finding that Shvarts received proper notice of the arbitration claim and hearing. The Hearing Officer granted Shvarts permission to amend his answer to correct the minor pleading error, but otherwise denied the motion, finding that the proposed additional defense was not germane to the question of liability in this proceeding, <u>i.e.</u>, whether Shvarts' failure to comply with the court

Hearing Panel Proceedings. At an initial pre-hearing conference, the parties agreed that the matter should be resolved through cross-motions for summary disposition because there were no material issues of fact in dispute.

On November 30, 1998, the parties filed their motions. Enforcement moved for summary disposition arguing that, as a matter of law, Enforcement was entitled to disposition in its favor because Shvarts had violated Conduct Rule 2110 by failing to pay the court-ordered attorney fees and costs. Shvarts filed a motion to dismiss the complaint arguing, among other things, that the conduct charged in the complaint was beyond the scope of Conduct Rule 2110 and the purview of the NASD's disciplinary authority. Shvarts also argued that, in the absence of a specific rule or interpretation, he had had insufficient notice that the non-payment of a court-ordered award could constitute a violation of Conduct Rule 2110.[9]

In connection with the motions, the parties offered exhibits, stipulated to the authenticity of the exhibits, and filed a joint stipulation concerning the relevant underlying facts. On March 5, 1999, the Hearing Panel heard oral argument on the motions by telephone conference call.

Hearing Panel Decision. The Hearing Panel concluded that the complaint was legally insufficient and that Shvarts was entitled to disposition in his favor.[10] The Hearing Panel dismissed the complaint, as described in more detail below.

Discussion

We hold that the Hearing Panel erred in granting summary disposition to Shvarts; we reverse that decision and award summary judgment, instead, to Enforcement.[11]

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order constituted a violation of Conduct Rule 2110. However, the Hearing Officer ruled that Shvarts could argue that the NASD's conduct should be considered a mitigating factor in imposing sanctions, if any.

9 Shvarts initially requested a hearing on sanctions in the event the Hearing Panel denied his motion to dismiss the complaint, but he later retracted this request.

10 The Hearing Panel noted that Shvarts had filed a motion to dismiss. The Hearing Panel noted that although the NASD Code of Procedure does not address motions to dismiss, Procedural Rule 9264(d) addresses motions for summary disposition. The Hearing Panel found that Shvarts' motion should technically be treated as a motion for summary disposition, rather than a motion to dismiss, because Shvarts relied on certain matters outside the pleadings.

11 Under Procedural Rule 9264(d), an adjudicator "may grant [a] motion for summary disposition if there is no genuine issue with regard to any material fact and the Party that files the motion is entitled to summary disposition as a matter of law." In such circumstances, the moving party bears the burden of demonstrating the absence of a genuine issue of material fact. Celotex Corp. v. Catrett, 477 U.S. 317 (1986). If the moving party meets this burden, the opposing party must come forward with specific facts showing that

Scope of Conduct Rule 2110. Section 15A of the Securities Exchange Act of 1934 (the "Exchange Act") requires the NASD, as a registered securities association, to have and enforce rules that "promote just and equitable principles of trade." The "special focus of the NASD's Rules is the professionalization of the securities industry," and the rules are "affirmatively and vaguely phrased in terms of what shall be instead of in terms of concrete proscriptions." Gustafson v. Strangis, 572 F. Supp. 1154, 1158 (D. Minn. 1983). Conduct Rule 2110 "is not limited to rules of legal conduct but rather . . . it states a broad ethical principle." In re Timothy L. Burkes, 51 S.E.C. 356 (1993), aff'd mem., Burkes v. SEC, 29 F.3d 630 (9th Cir. July 24, 1994). Disciplinary hearings under Conduct Rule 2110 are ethical proceedings, and one may find a violation of the ethical requirements where no legally cognizable wrong occurred. Id. The NASD has authority to impose sanctions for violations of "moral standards" even if there was no "unlawful" conduct. In re Benjamin Werner, 44 S.E.C. 622 (1971).[12]

The ethical standards imposed in disciplinary proceedings go beyond legal requirements and depend on general rules of fair dealing, the reasonable expectations of the parties, marketplace practices, and the relationship between the firm and the customer. In re E.F. Hutton & Co., Inc., 49 S.E.C. 829 (1988) (the "Manning case"). "[A] member's failure to live up to obligations owed to a customer or to a fellow member constitutes a breach of 'just and equitable principles of trade.'" In re NASD, Inc., 19 S.E.C. 424 (1945). The rule "sets forth a standard intended to encompass a wide variety of conduct that may operate as an injustice to investors or other participants in the marketplace." In re Daniel Joseph Alderman, 52 S.E.C. 366, 369 (1995), aff'd, 104 F.3d 285 (9th Cir. 1997).

Conduct Rule 2110 requires adherence to "high standards of commercial honor and just and equitable principles of trade." In the caselaw developed under the rule, some types of misconduct, such as violations of federal securities laws and NASD Conduct Rules, are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations. E.g., In re L.H. Alton & Co., et al., Exchange Act Rel. No. 40886, at 5 (Jan. 6, 1999) (violations of the net capital rule were violations of Conduct Rule 2110); cf. In re Richard J. Rouse, 51 S.E.C. 581, 586 n.14 (1993). Other types of violations, such as failures to honor obligations imposed by private contracts, are viewed as violations of Conduct Rule 2110 only if the surrounding facts and circumstances indicate that the conduct was unethical. The concepts of excuse, justification, and "bad faith" may be employed to determine whether conduct is unethical in these cases.

The NASD and the SEC first explored the concepts of justification and bad faith in disciplinary cases brought against NASD member firms for breaches of contract with other member firms. The Commission has recognized that "[i]t is not the function of the SEC, or of the NASD, in applying [Conduct Rule 2110], to decide private contract rights between the parties" and that "[t]he Rule states a broad ethical principle and the question presented thereunder is whether the member's conduct in question

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there is a genuine issue in dispute. Matsushita Elec. Indus. Corp. v. Zenith Radio Co., 475 U.S. 574 (1986). Absent such a showing, summary judgment is appropriate.

12 Conduct Rule 2110 was formerly known as Article III, Section 1 of the NASD Rules of Fair Practice.

violates standards of fair dealing." In re Samuel B. Franklin & Co, 38 S.E.C. 113, 116 (1957). The Commission has also held that:

> [I]n the absence of justifying or extenuating circumstances a member's failure to live up to contract obligations owed to a customer or fellow member would constitute dishonorable and inequitable conduct not consistent with 'just and equitable principles of trade' as that term is generally employed. However ... not ... every failure to perform a contract violates [Conduct Rule 2110]. To come within [Conduct Rule 2110] it should appear that the breach was committed without equitable excuse or justification.

In re Lerner & Co., et al., 37 S.E.C. 850 (1957). A breach of contract is permissible if "colorably justified by the confusion as to the true state of the market and as to the applicable law." Buchman v. SEC, 553 F.2d 816, 820 (2d Cir. 1977). "The touchstone, in other words, is good faith -- the ultimate test of violation of an ethical standard," and "[a] breach of contract is unethical conduct in violation of NASD Rules only if it is in bad faith." Buchman, 553 F.2d at 821.

The concepts of excuse, justification, and good and bad faith also are employed in cases in which an associated person's obligations to a customer are at issue. The analysis that is employed is a flexible evaluation of the surrounding circumstances with attention to the ethical nature of the conduct. See In re William D. George, III, 47 S.E.C. 368 (1980) (a failure promptly to reimburse a customer pursuant to an indemnity agreement may breach ethical standards if there is bad faith, but there was no violation where customers neither expected nor requested prompt payment); In re John C. Gebura, 46 S.E.C. 1121 (1977) (associated person involved in private securities transaction violated Conduct Rule 2110 by improperly withholding customer funds and "deliberately taking advantage of an unsophisticated customer"). If a registered representative borrows money from a customer, the surrounding circumstances determine whether a violation of Conduct Rule 2110 is involved. See In re Terry Wayne White, 50 S.E.C. 211 (1990) (a representative's inducing an elderly customer to make a large, unsecured loan violated Conduct Rule 2110 because the conduct was "far removed from the boundaries of just and equitable principles of trade"); In re Robert J. Jautz, 48 S.E.C. 702 (1987) (a representative's borrowing money from a customer was not unethical since there was no pressure, misrepresentation, or advantage taken; the representative's failure promptly to repay the loan did not violate Rule 2110 because he was not acting in bad faith but instead was simply unable to pay). "Bad faith" in the sense of malicious intent or deceitfulness need not be established. Thus, a director of a firm who delayed refunding customer funds to customers violated Conduct Rule 2110 because, having acted purposefully, he had acted "at least unethically." See In re Daniel Joseph Alderman 52 S.E.C. 366, 369 (1995), aff'd, 104 F.3d 285 (9th Cir. 1997).

Finally, we note that Conduct Rule 2110 is not limited to securities-related conduct; instead, it covers all unethical business-related conduct. E.g., In re Ernest A. Cipriani, 51 S.E.C. 1004 (1994) (insurance agent misappropriated money from insurance -- not securities -- customer); In re Henry E. Vail, 52 S.E.C. 339, 342 (1995) (treasurer of political club breached his "significant fiduciary obligations" to the club and thereby violated Conduct Rule 2110 when he misappropriated club funds), aff'd mem., Vail v. SEC, 101 F. 3d 37, 39 (5th Cir. 1996) ("the SEC has consistently held that the NASD's disciplinary authority is broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade, even if that activity does not involve a security"). See also In re James A. Goetz, Exchange Act Rel. No. 39796 (March 25, 1998) (respondent improperly obtained a donation for his daughter's private school tuition from his member firm's matching gifts program by misrepresenting that he had contributed personal funds); In re Leonard J. Ialeggio, 52 S.E.C. 1085 (1996) (associated person improperly obtained reimbursement for country club initiation fees from his employer firm), aff'd mem., (9th Cir. May 20, 1999); In re William F. Rembert, 51 S.E.C. 825 (1993) (respondent cheated employer to increase commissions); In re Timothy L. Burkes, 51 S.E.C. 356 (1993) (representative tried to persuade back-office employee to credit him commissions), aff'd mem., 29 F.3d 630 (9th Cir. July 24, 1994); In re George R. Beall, Jr., 50 S.E.C. 230 (1990) (respondent passed bad checks to employer). Thus, it is clear that misconduct that is not securities-related is prohibited by Conduct Rule 2110 if it occurs in the conduct of the respondent's business.

Applicability of Conduct Rule 2110 to Shvarts' Conduct. We now turn to the applicability of Conduct Rule 2110 in this case. The rule states in its entirety: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." Thus, the rule's language requires that two tests be met: (1) the misconduct occurred "in the conduct of" the respondent's business; and (2) the misconduct violated just and equitable principles of trade. We find that both tests are met here.

We find that the facts here present no basis for questioning that Shvarts' failure to pay the award of fees occurred "in the conduct of his business." Shvarts had no connection with the O's other than the fact that they were dissatisfied former customers of his brokerage firm. The O's filed an arbitration claim regarding their complaints about the conduct of that business, and they won in the arbitration proceedings. Shvarts then filed a lawsuit against the O's, his former customers, challenging the award. He lost and was ordered to pay attorney fees to reimburse the O's for the expenses they had incurred in the lawsuit. He did not pay. We find that Shvarts' obligation to pay the attorney fees, as well as his failure to pay, occurred "in the conduct of his business."

Moreover, the caselaw under Conduct Rule 2110 clearly supports a holding that Shvarts' failure to pay occurred in the conduct of his business. The NASD's rule requiring ethical conduct obviously applies to dealings with securities customers. E.g., Leonard John Ialeggio v. SEC, No. 98-70854 (9th Cir. May 20, 1999) (under Conduct Rule 2110, "[one's] 'business' includes . . . his commercial relationships with his customers").[13] When customers have complaints about their securities accounts, it is beyond question that the associated person's response to the complaint is within the conduct of the associated person's business. In addition, it is well established that arbitration proceedings initiated by dissatisfied customers are within the conduct of an associated person's business; hence, associated persons, who agree upon entering the

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In addition, business relationships with customers beyond those concerned with securities accounts are viewed as within the conduct of one's business. E.g., In re Henry E. Vail, 52 S.E.C. 339 (1995) (treasurer of political club breached obligations to the club), aff'd mem., Vail v. SEC, 101 F. 3d 37, 39 (5th Cir. 1996); In re Ernest A. Cipriani, 51 S.E.C. 1004 (1994) (misappropriation from insurance customer); In re Terry Wayne White, 50 S.E.C. 211 (1990) (private loan to representative from customer).

industry to participate in arbitration with customers, may violate Conduct Rule 2110 if they fabricate evidence in arbitration proceedings or fail to make prompt efforts to pay arbitration awards. See Uniform Application for Securities Industry Registration or Transfer ("Form U-4"); In re John F. Noonan, 52 S.E.C. 262 (1996); In re James M. Bowen, 51 S.E.C. 1152 (1994). The fact that Shvarts transferred his dispute with the O's from NASD arbitration to a new forum -- a state court -- did not isolate the dispute from the conduct of his business or relieve him of his ethical obligations. Court proceedings relating to arbitration are a foreseeable aspect of commercial dealings with customers. In sum, we find that Shvarts' disputes with the O's, his use of dispute resolution systems to address those disputes, and his lack of compliance with an order of an adjudicator in one of those dispute resolution systems, were all within "the conduct of his business" as aspects of his commercial relationship with the O's.

We also find that Shvarts' failure to pay the award of fees was violative of just and equitable principles of trade, i.e., that it met the second prong of the two-part test applicable under the language of Conduct Rule 2110. As described in more detail below, we find that Shvarts' conduct is actionable under Conduct Rule 2110 under either of two approaches: First, we view Shvarts' violation of a court order as the equivalent of a violation of a securities law or rule and hence as violative of Conduct Rule 2110. Second, we find that even if the violation of the court order were not in itself a violation of Conduct Rule 2110, Shvarts' conduct would still be violative because it was unethical.

We hold that Shvarts' failure to comply with the court order awarding attorney fees and costs to the O's was the sort of behavior that in itself violates Conduct Rule 2110, barring extraordinary circumstances. We find that, just as associated persons are required under "high standards of commercial honor and just and equitable principles of trade" to comply with the securities statutes and rules, they also are required to comply with court orders issued in business-related cases. Although we are unaware of any prior disciplinary case in which a violation of a court order issued in private litigation was at issue, we note that the SEC has recognized that a Conduct Rule 2110 violation occurs when an individual violates a regulatory consent order. In In re Gordon Wesley Sodorff, 50 S.E.C. 1249 (1992), the respondent had executed a consent order with a state securities regulator in which he agreed to obtain permission prior to engaging in outside securities transactions. He subsequently was named in a disciplinary action for selling away. The SEC affirmed the NASD's finding that he had violated the NASD rule against selling away. The SEC also held, however, that he had violated Conduct Rule 2110, and that "his conduct went beyond [the NASD rule] violation" because "[t]he Consent Order created an independent duty for Sodorff to obtain permission ... before effecting any outside securities transaction." We find that the court order in this matter -- concerning, as it did, Shvarts' litigation against his former customers about their securities- and business-related arbitration claim against him -- created an independent duty with which Shvarts was obliged to comply, and that his failure to abide by the order violated Conduct Rule 2110.[14]

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We note that the rule's requirement that the subject of the violation occur "in the conduct of" one's business would preclude application of the rule in a setting unrelated to the NASD's regulatory authority, such as a case in which an associated person is accused of violating a court order in a divorce proceeding. We also note that unusual circumstances could make a particular violation of a business-related court order excusable under Conduct Rule 2110, just as such circumstances may mean that a violation of an NASD rule will not be viewed as a violation of Conduct Rule 2110. See In re Richard J. Rouse, 51 S.E.C. 581, We also hold that Shvarts' conduct was violative because it was unethical. Shvarts' conduct was unethical because he breached his duties to his former customers. "[A] broker/dealer's professional 'shingle' impliedly represents that he will engage in fair and honest dealings with customers, according to industry standards." Market Surveillance Committee v. R. B. Marich, Inc. et al., Complaint No. MS-849, n. 27 (NBCC Decision Dec. 23, 1991). "Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession." In re Duker & Duker, 6 S.E.C. 386, 388-89 (1939). "[A] member's failure to live up to obligations owed to a customer . . . constitutes a breach of 'just and equitable principles of trade.'" In re NASD, Inc., 19 S.E.C. 424 (1945). We find that it was unethical for Shvarts to refuse to pay the attorney fees and costs awarded by the court. When Shvarts sued his former customers about their arbitration claim against him, he submitted himself to the jurisdiction of the state court and forced the O's to incur the costs of defending the lawsuit. Given these circumstances, Shvarts should have played by the rules of the game in which he forced the O's to join: Because the court determined that he owed the attorney fees and costs to the O's, he should have paid. His failure to pay was "dishonorable and inequitable conduct," see Lerner & Co., supra, which has "operate[d] as an injustice to investors," see Alderman, 52 S.E.C. at 369.[15]

Shvarts' Arguments in Defense. We reject each of Shvarts' arguments in defense.[16] First, Shvarts, who claims to have filed the lawsuit to establish whether he was served properly in the arbitration

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586 n.14 (1993) (delayed response to NASD requests for information was sufficiently mitigated by the "highly extraordinary extenuating circumstances" that no Conduct Rule 2110 violation was established). Shvarts, however, has offered no excuse or justification for his failure to pay the attorney fees.

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In addition, we find that Shvarts' conduct was unethical because it undermined the NASD's regulatory functions by discouraging customer use of the arbitration system. The purpose of the arbitration system is "to provide speedy resolution of disputes among members, their employees, and the public," and a failure to pay an arbitration award is generally viewed as a violation of Conduct Rule 2110. In re James M. Bowen, 51 S.E.C. 1152, 1153 (1994); see also, e.g., In re Stix & Co., Inc., 46 S.E.C. 578, 579 (1976). Shvarts' failure to pay the award of attorney fees and costs, if condoned, could discourage arbitration proceedings -- and the private attorneys who might represent defrauded investors -- by reducing the consequences of instituting frivolous litigation against customers who initiate arbitration proceedings. Thus, Shvarts' conduct undermined the regulatory function of fostering an effective dispute resolution system. As such, this undermining of the NASD's regulatory functions was violative of Conduct Rule 2110. See In re Stratton Oakmont, Inc., 52 S.E.C. 1170 (1997) (utilizing a settlement agreement which restricts a complaining customer's cooperation with regulators violates Conduct Rule 2110); Noonan, 52 S.E.C. at 265 ("Actions such as [fabrication of evidence] totally subvert the arbitration process. Under no circumstances can such conduct be tolerated."); In re William Edward Daniel, 50 S.E.C. at 332 (1990) (offering to settle a complaint contingent upon customer's withdrawal of complaint with NASD violates Conduct Rule 2110).

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Shvarts also argued that this matter was beyond our jurisdiction, but as previously discussed, we reject this argument. We also reject Shvarts' claim that we must decide this case based upon a "clear and convincing evidence" standard; the applicable standard is the preponderance of the evidence. E.g., Cipriani, supra.

proceedings, argues that he was entitled to establish this fact and that imposing sanctions here would unfairly burden his right of access to the courts. We are unpersuaded by these arguments. We are holding that Shvarts' failure to comply with the court order violated Conduct Rule 2110, not that his filing a lawsuit violated the rule.[17]

We also hold that Shvarts was required to honor the court award regardless of the basis for it. The award was issued in court proceedings that he initiated against his customers about their arbitration claim against him. Just as we require associated persons to honor arbitration awards without second-guessing the evidence underlying the award, e.g., In re Stix & Co., Inc., 46 S.E.C. at 580, we find it appropriate to require associated persons to honor attorney fees awards entered against them in arbitration-related litigation that they initiate. It is our view that, if an associated person files suit against a customer regarding a customer dispute, the associated person must comply with court orders issued in the ensuing litigation.

Shvarts also claims that the NASD's loss of the arbitration case file necessitated the evidentiary hearing, obliging the parties to spend more on attorney fees. We hold, however, that he cannot collaterally attack the court order in this fashion. See In re John G. Pearce, 52 S.E.C. 796 (1996) (respondent who failed to pay an arbitration award claimed that his court challenge had been impaired because the NASD had failed to make tapes of the arbitration; SEC held that he could not raise this argument in the disciplinary

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In addition, although assessing the merits of the Florida state court litigation is not necessary to our finding of a violation of Conduct Rule 2110, we find that the judgment of the court awarding attorney fees indicates that Shvarts was not simply "exercising his legal rights" (to paraphrase the Hearing Panel) when he initiated the state court litigation. Even though Shvarts filed a lawsuit claiming that he was not served with notice of the arbitration, and he now argues that he was hospitalized (apparently for substance abuse treatment) at the time of the first arbitration hearing, he does not actually claim to us that he was not served. There are hints in the record -- such as the arbitration panel's account of Montelone's testimony -- that Shvarts acknowledged having been served with notice of the arbitration claim.

The statute authorizing the award is clear. Section 57.105(1) of the Florida statutes states in full:

> [t]he court shall award a reasonable attorney's fee to be paid to the prevailing party in equal amounts by the losing party and the losing party's attorney in any civil action in which the court finds that there was a complete absence of a justiciable issue of either law or fact raised by the complaint or defense of the losing party; provided, however, that the losing party's attorney is not personally responsible if he or she has acted in good faith, based on the representations of his or her client. (Emphasis added.)

Under this statute, the award of fees against Shvarts (and not against his counsel) necessarily entailed a determination that Shvarts' civil complaint lacked any legal or factual basis. Thus, the court determined that Shvarts had filed a frivolous lawsuit against his customers.

proceeding because he could not be permitted to attack collaterally the arbitration proceeding in the disciplinary proceeding).

In addition, Shvarts argues that the Florida award of attorney fees is not directly enforceable against him and that, if the O's wish to collect on it, they must pursue him to his home state of New York and take legal steps to attempt to collect it there.[18] We find that this argument is unavailing as a substantive defense. Shvarts stipulated in this disciplinary action to a factual finding that the Florida court "issued a judgment ordering [the firm] and Shvarts to pay the attorney's fees and costs." Moreover, Shvarts filed suit against the O's in Florida while he was represented by Florida counsel. When he did so, he submitted himself to the jurisdiction of the Florida court. Thus, we find that his failure to comply with the Florida court's order is dishonorable and inequitable, and in violation of Conduct Rule 2110, regardless of its import in a New York State court.[19]

Finally, Shvarts also argues that applying Conduct Rule 2110 here would constitute an invalid rule change and that Conduct Rule 2110 is unconstitutionally vague. We reject these arguments. Because Conduct Rule 2110 clearly applies to Shvarts' misconduct, our holding here involves no rule change, and thus no rule-filing was necessary. As the Commission has held, a new application of Conduct Rule 2110 is not an invalid rule change where it does not establish a new standard of conduct and where the application can be "reasonably and fairly implied" from Conduct Rule 2110 and the Exchange Act. <u>In re Stratton</u>

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The November 24, 1997 order, entitled "Final Judgment Awarding Defendants Fees and Costs for Trial and Appeal Against Plaintiffs Aleksandr Shvarts and American Bond Group, Inc.," contained the following statements:

> By Order dated April 23, 1997, the Fourth District Court of Appeal determined that the Defendants were entitled to tax reasonable attorney's fees and costs incurred on appeal. By ruling issued from the bench on August 26, 1997, this Court determined that the Defendants were also entitled to tax reasonable attorney's fees and costs at the trial level against Plaintiffs, but not their counsel. . . . [T]he Court hereby finds as follows . . . IT IS HEREBY ORDERED AND ADJUDGED: Defendants [the O's] shall recover from Plaintiffs Aleksander Shvrarts and American Bond Group, Inc., jointly and severally, the sum of $45,915.10, plus interest of $1,736.02 through this date, for a total award of $47,651.12, representing the reasonable attorney's fees and costs incurred at the trial level and on appeal in this case, with postjudgment interest to accrue at the statutory rate of 10% per annum, for which sum let execution issue.

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Similarly, in <u>In re Daniel Joseph Alderman</u>, 52 S.E.C. 366 (1995), <u>aff'd</u>, 104 F.3d 285 (9th Cir. 1997), the SEC included in the appellate brief filed with the court of appeals attention to Alderman's claim that he had not been obligated under state law to return the money mistakenly diverted from customers. The SEC noted that Alderman's assertion was off-point because regardless of state law, he had failed to comply with his obligations under the NASD rules to see that the money was returned.

Oakmont, Inc., 52 S.E.C. 1170 (1997) (affirming imposition of sanctions for use of settlement agreements that restricted customer cooperation with regulators).

Moreover, the Commission and the courts have repeatedly affirmed that Conduct Rule 2110 is not unconstitutionally vague as applied to new varieties of unethical conduct. E.g., Leonard John Ialeggio v. SEC, No. 98-70854 (9th Cir. May 20, 1999) (expense account cheating). Objections to vagueness under the Due Process Clause, which rest on a lack of notice, may be overcome in a case where reasonable persons would know that their conduct is at risk. Maynard v. Cartwright, 486 U.S. 356, 361 (1988). "Challenges to [Conduct Rule 2110] on vagueness grounds have generally failed, where application of the rule to the particular misconduct 'cannot have come as a surprise.'" Alderman v. S.E.C., 104 F.3d 285, 289 (9th Cir. 1997). We hold that Shvarts should have known that his conduct was dishonorable and inequitable.

Hearing Panel Analysis. Having explained our analysis of this matter, we will now address the analysis of the Hearing Panel, which concluded that the complaint failed to state a cognizable claim under Conduct Rule 2110 and that the conduct charged was outside the scope of the NASD's self-regulatory responsibilities.

First, the Hearing Panel stated that there typically must be a "nexus" between the allegedly unethical conduct and an associated person's business activities. We find, however, that there is no need to establish a "nexus" because all of the events at issue here -- the customer relationship, the customers' arbitration claim, the related lawsuit, the court order, and Shvarts' failure to pay -- were aspects of Shvarts' commercial dealings with his customers and were themselves within the conduct of Shvarts' business.

In addition, the Hearing Panel found that Shvarts' misconduct was different from several situations known to fall within Conduct Rule 2110: (1) misappropriation or misuse of customer funds; (2) improper withholding of customer funds; or (3) improper exploitation of a relationship with a customer to obtain a loan and then failing to repay the loan. The Hearing Panel found that each of these situations, in addition to involving funds originally belonging to a customer, involves misconduct that "necessarily flows from, and is inextricably intertwined with, the associated person's conduct as a securities professional." We find, however, that the Hearing Panel's reading of Conduct Rule 2110 was unduly narrow, in view of the numerous cases, such as Cipriani and Vail, supra, involving misconduct that was not securities-related. We also find that, in any event, Shvarts' failure to pay the attorney fees did flow from and was inextricably intertwined with his conduct as a securities professional.

Our most fundamental difference with the Hearing Panel rests in identification of the essential nature of this case. The Hearing Panel found that even though Shvarts was in contempt of a court order and his contemptuous conduct had harmed his former customers, the disciplinary complaint in this matter concerned "a civil litigant's failure to satisfy an order of a court that had the collateral consequences of depriving civil litigants, who also were customers, of economic relief they were awarded in a different, though related proceeding" (emphasis added). The Hearing Panel also held that Shvarts' conduct related to the integrity of the judicial processes of a state court, rather than being business-related conduct or conduct relating to the NASD's arbitration processes.[20] We disagree with the Hearing Panel's analysis of the nature of this case. This NASD disciplinary action was brought under Conduct Rule 2110 as an ethical proceeding. Bearing in mind the NASD's regulatory responsibilities under the Exchange Act, we find, in assessing whether Shvarts' flaunting the order to pay attorney fees and costs was "just and equitable," that the NASD cannot condone the harm that Shvarts inflicted upon the O's by not paying the attorney fees and costs that he obliged them to spend and which he has been ordered to pay. We do not view the Os' harm as a "collateral" consequence, and we do not find that their identities as "customers" were diminished simply because Shvarts forced them to become "civil litigants" when he sued them.

The Hearing Panel also concluded that "the NASD, as a matter of policy, should not extend its disciplinary authority to institute proceedings against and sanction associated persons for violating orders entered by state or federal courts, or other tribunals." We find, however, that the Hearing Panel's policy analysis was unnecessary because no "extension" of disciplinary authority is involved in this case. We also disagree with the Hearing Panel's analysis of the particular policy implications of this case.

First, the Hearing Panel stated that it was troubled by the possibility of extending Conduct Rule 2110 to discipline associated persons for pursuing their legal rights. We have already discussed, in connection with Shvarts' defenses, our lack of belief that our holding could penalize Shvarts for pursuing his legal rights. In addition, we reject the Hearing Panel's implication that the "pursuit of legal rights" can somehow confer immunity from discipline under Conduct Rule 2110, and we find that if a respondent engages in unethical and dishonorable business-related conduct in litigation, disciplinary sanctions may be imposed. The Hearing Panel also reasoned that the courts have the power to sanction individuals who ignore court orders. The fact that the courts may address contemptuous misconduct, however, does not persuade us that the NASD should be excused from its own obligation to enforce just and equitable principles of trade.

We find that policy considerations favor applying Conduct Rule 2110 to Shvarts' misconduct. Even though the court that heard the litigation ordered Shvarts to pay his former clients' attorney fees in November 1997, he still refuses to pay the attorney fees. This result, if allowed to stand, would be unfair to the O's in particular. Moreover, this result could serve as a great disincentive to injured customers considering whether to pursue their remedies in arbitration, as well as to attorneys considering whether to represent them, and these disincentives would be contrary to the NASD's stated policy of supporting the efficient, speedy resolution of disputes through arbitration. Thus, we find that making findings of violation in this matter will serve the public interest by upholding the securities industry's reputation as an industry conducted on a legal and ethical basis.[21]

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The Hearing Panel noted, quoting Muckenfuss v. Deltona Corp., 508 So. 2d 340, 341 (Fla. 1987), that the court had awarded attorney fees against Shvarts pursuant to a statute designed to discourage "baseless claims, stonewall defenses and sham appeals in civil litigation," and, quoting Chambers v. NASCO, Inc., 501 U.S. 32, 45 (1991), that awards of attorney fees are a "matter of vindicating judicial authority" and intended to remedy conduct that "'abuses the judicial process.'"

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We also note that in general, policing non-securities related misconduct serves the public interest by

The Hearing Panel also noted that practical problems could arise if the NASD attempted to discipline associated persons for failures to comply with other tribunals' orders. The Hearing Panel found that NASD adjudicators would be required to give deference to another tribunal's order, and that where the trial court's reasons for imposing sanctions were not clear, it would be difficult for the NASD adjudicator to assess the egregiousness of a respondent's conduct. We are not unduly troubled by these issues. We note that we already give deference to other tribunals in all sorts of settings, including arbitration awards (since we refuse to review the sufficiency of the evidence supporting an arbitration award when we require an associated person to pay it) and statutory disqualification proceedings. In addition, we note that potential difficulties in assessing the egregiousness of a respondent's conduct do not present a large obstacle; as in other types of disciplinary cases, adjudicators can impose disciplinary sanctions only to the extent that they are appropriately remedial based upon the record. The fact that some records may be lacking at some times should not prevent adjudicators from enforcing the rule in all such cases.

Sanctions

We note that no NASD Sanction Guideline ("Guideline") is applicable to this misconduct[22] and that Shvarts has a disciplinary history. In 1992 and 1994, he settled two NASD cases (involving violation of a restriction agreement and failure to respond to requests for information) for censures and fines of $2,500 or less. Between August 1995 and January 1996, his registration was suspended for failure to pay an unrelated arbitration award. In 1998, he settled Complaint No. C10970133, which alleged failure timely to execute sale orders for 13 customers, and he agreed to a censure, a $25,000 fine, requalification by examination, a 10-day suspension in all capacities, and a 30-day suspension as a principal. In June 1999, however, his NASD registration was revoked because he had failed to pay the fine to which he had agreed.

Given this background, we order that Shvarts be fined $5,000 and suspended from association with any member firm in any capacity for six months. We also order Shvarts to pay the award of attorney fees and costs to the O's. If Shvarts does not submit proof that he has paid the attorney fees and costs

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protecting the public from individuals potentially likely to harm the public. See, e.g., In re Leonard John Ialeggio, 52 S.E.C. 1085 (1996) (expense-account cheating "cast doubt on [respondent's] commitment to the fiduciary standards demanded of registered persons in the securities industry and thus properly [were] the subject of NASD disciplinary action."), aff'd mem. (9th Cir. May 20, 1999); In re James A. Goetz, Exchange Act Rel. No. 39796 (Mar. 25, 1998) (arrangement for improper donation to private school "reflect[ed] directly on Goetz's ability both to comply with regulatory requirements fundamental to the securities business and to fulfill his fiduciary responsibilities in handling other people's money").

22 The NASD Sanction Guideline for failures to honor arbitration awards recommends a fine of at least $5,000 and a suspension in all capacities until the respondent satisfies the arbitration award, plus at least 30 additional business days, or a bar in egregious cases. NASD Sanction Guidelines (1998 ed.) at 18 (Arbitration Award - Failure to Honor or Failure to Honor in a Timely Manner).

within 60 days of the date of this decision, he shall be barred from association with any NASD member firm in any capacity.

Given Shvarts' status as an individual whose registration has been revoked for failure to pay an NASD fine, our ability to address his misconduct is somewhat limited. The sanctions we are imposing here will, however, ensure that Shvarts cannot work in the securities industry unless he pays the attorney fees and costs to the O's.

Accordingly, Shvarts is fined $5,000, suspended for six months, and ordered to submit to the Department of Enforcement, within 60 days of the date of this decision, proof that he has paid to his former customers, the O's, the sum of $47,651.12, plus interest calculated at an annual rate of 10 percent from November 24, 1997. If Shvarts does not submit such proof of payment to the customers, he shall be barred from association with any member firm in any capacity.[23] The suspension will begin 30 days after the issuance of this decision.

On Behalf of the National Adjudicatory Council,

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Joan C. Conley, Senior Vice President and Corporate Secretary

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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 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 sanction, after seven days' notice in writing, will summarily be revoked for non-payment.