BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

District Business Conduct Committee for District No. 2	)	DECISION
Complainant,	)	Complaint No. C02960001
vs.	)	District No. 2 (LA)
Harold B. Gallison, Jr., Gregory K. Mehlmann, Robert C. Weaver, Gerald R. Budke, Christopher S. Knight, La Jolla Capital Corporation,	)	Dated: February 5, 1999
San Diego, CA,	)	
Respondents.	)	

On September 5, 1997, the District Business Conduct Committee for District No. 2 ("DBCC") issued a decision in which it found that the following respondents had violated the NASD Conduct and Membership and Registration Rules: La Jolla Capital Corporation ("La Jolla" or "the Firm"), Harold B. Gallison, Jr. ("Gallison"), Gregory K. Mehlmann ("Mehlmann"), Robert C. Weaver ("Weaver"), Gerald R. Budke ("Budke"), and Christopher S. Knight ("Knight") (collectively, "Respondents").[1] The Respondents appealed that decision pursuant to NASD Procedural Rule 9312.

We find that La Jolla, Gallison, and Knight violated the Securities and Exchange Commission's ("Commission") penny stock rules by failing to disclose required information to their customers; that La Jolla, Gallison, Mehlmann and Knight failed to establish, maintain, and enforce written procedures reasonably designed to supervise La Jolla's penny stock sales practices; and that Knight violated the NASD's Membership and Registration Rules by permitting unregistered persons to engage in the securities business at La Jolla's New York office. We further find that Budke and Weaver did not violate any NASD Conduct Rules.

Accordingly, we impose the following sanctions: La Jolla and Gallison are censured; barred from engaging in penny stock transactions in any capacity; fined $297,380, jointly and severally; fined $50,000 each individually; and required to present proof of restitution or recission to their damaged customers. Gallison is also barred in all principal and supervisory capacities, and suspended in all capacities for 30 days. Knight is censured; barred in all principal

[1] La Jolla, Gallison, Weaver, Mehlmann and Budke were jointly represented by counsel. Knight was represented by separate counsel.

and supervisory capacities, barred from engaging in penny stock transactions in any capacity; fined $95,854.55; and suspended in all capacities for 15 days. Mehlmann is censured; fined $10,000; suspended in all principal and supervisory capacities for 10 days; and required to requalify as a general securities principal. The Respondents are assessed $19,460.75 in DBCC costs.

I. INTRODUCTION

The complaint, filed on January 25, 1996, asserts seven causes of action against La Jolla and 23 of its employees. Eighteen of the individual respondents settled the allegations against them, leaving the current respondents. Cause One alleges that La Jolla, Gallison, Knight, and Budke violated the Commission's so-called "Penny Stock Rules," and NASD Conduct Rule 2110, by failing to make adequate disclosure to their customers who purchased penny stocks. Cause Two alleges that La Jolla, Gallison, Weaver, Mehlmann, and Knight violated NASD Conduct Rule 3010 by failing to establish, maintain and enforce procedures reasonably designed to detect and prevent violations of these Penny Stock Rules. Cause Three alleges that La Jolla, Gallison and Mehlmann violated Commission Rule 15g-6 by failing to provide penny stock customers with a written account statement containing a "conspicuous" disclosure.[2] Cause Five alleges that Knight violated NASD Conduct Rule 2110 and Membership and Registration Rule 1031 by permitting unregistered personnel to engage in the securities business at La Jolla's New York Office while he managed that office.

La Jolla became an NASD member in 1990. During the relevant time period, January 1994 to May 1995, the Firm had as many as 125 registered representatives at its San Diego headquarters and its offices of supervisory jurisdiction in, among other places, New York, New York ("New York Office"), Modesto, California ("Modesto Office"), Bethesda, Maryland ("Bethesda Office"), and Las Vegas, Nevada ("Las Vegas Office"). La Jolla's penny stock business accounted for 5 percent of its total business, but a substantially higher percentage of the business of the New York and Bethesda Offices.

The individual respondents each held an executive or managerial position at La Jolla during the relevant period. Gallison was the Firm's President, Head Trader, Chief Compliance Officer, and controlling shareholder.[3][4] Weaver was the Firm's Executive Vice President, Chief Legal Counsel, Secretary and Treasurer, member of the Board of Directors, and a 30 percent

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[2] The disclosure that Rule 15g-6 requires was printed in capital letters in the last paragraph, set apart by a blank line, on the back of La Jolla's customer account statements, which La Jolla's clearing agent prepared. At the DBCC hearing, the Staff of NASD Regulation, Inc. ("NASD Regulation") presented no evidence that the disclosure was not conspicuous. On appeal, the Staff offers no argument to resurrect its case. We, therefore, affirm the DBCC's dismissal of cause three.

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[4] Gallison entered the securities industry in 1982. In April 1989, following association with several NASD members, Gallison became registered as a general securities representative, general securities principal, financial and operations principal and options principal. Gallison purchased La Jolla in 1991 and became registered with La Jolla in August of 1992.

shareholder in the Firm.[5] Mehlmann was a general securities principal and the Firm's National Franchise Compliance Officer.[6] Budke was the sole registered person and manager of La Jolla's Modesto Office,[7] and, as set forth below, Knight was the manager of La Jolla's New York Office.[8]

Because the penny stock rules are at the heart of this case, it will be useful to explore the history and substance of these rules before turning to the facts. Penny stocks are non-Nasdaq and non-exchange-listed equity securities, currently priced less than $5 per share, that are issued by companies with less than a specified amount of net tangible assets, continuous operations, or annual revenues. See 17 C.F.R. 240.3a51-1 (1998). In 1989, the Commission adopted Rule 15c2-6 to reduce "unscrupulous, high pressure sales tactics of certain broker/dealers by imposing objective and readily reviewable requirements" for penny stock transactions. Exchange Act Rel. No. 27160 (August 22, 1989). Rule 15c2-6 prohibited firms from selling to, or effecting the purchase of, penny stocks by any person, unless the firm had pre-approved the purchaser's account for penny stock transactions, and had received the purchaser's written agreement to the transaction. See Notices to Members ("NTM") 89-65 (October 1989), and NTM 90-18 (March 1990).

Following the adoption of Rule 15c2-6, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("The Reform Act") to tighten the regulation of broker/dealers that recommend penny stock transactions to their customers and to promote the development of a structured electronic marketplace for dealers to quote such securities. The Reform Act directed the Commission to adopt rules requiring firms to provide investors with material market information before effecting penny stock transactions.

In response, the Commission adopted the Penny Stock Disclosure Rules -- Rule 3a51-1 and Rules 15g-1 through 15g-6, 17 C.F.R. 240.15g-1 through 240.15g-6 ("Disclosure Rules"),

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5 Weaver passed the Series 1 examination in 1966 and the Series 24 examination in 1991, and he obtained his law degree in 1978. In August 1991 he became registered with La Jolla as a general securities representative and general securities principal, and, until early 1992, he was the Firm's President. Weaver terminated his association with La Jolla in December of 1997, and he is currently registered with another NASD member.

6 Mehlmann entered the securities industry in 1976. He passed the Series 7 examination in 1976 and the Series 24 examination in October 1981. From 1989 through 1993 Mehlmann was not active in the securities industry. Mehlmann was associated with La Jolla from September of 1993 through July of 1995. He is not currently associated with another NASD member.

7 Budke entered the securities industry in 1983, and passed the Series 24 examination in July of 1988. Following associations with a number of firms, Budke became associated with La Jolla in January 1993, and he remains with La Jolla as a general securities principal.

8 Knight first became registered as a general securities representative in 1987 through Investors Center, Inc. In August 1990, he passed the general securities principal examination. Since that time Knight has been registered through a number of member firms. In April 1993, he registered with Burnett, Grey & Co., Inc., as a general securities principal. In March of 1994 he registered with La Jolla when the Firm assumed control of another member's New York City office. Knight remained with La Jolla until April of 1997, and he is not currently associated with an NASD member.

which took effect on January 1, 1993. The Disclosure Rules require broker/dealers to provide their penny stock customers with information concerning the general risks of penny stocks, and the specific nature of their penny stock purchases. Rule 15g-2 requires that each customer receive a Risk Disclosure Document describing the risks of investing in penny stocks, and that the firm obtain a signed acknowledgment of receipt of that document. Rule 15g-3 requires oral and written disclosure of inside bid and ask quotations prior to a penny stock trade, and written confirmation following. Firms must disclose the compensation of the broker/dealer and salesperson involved in the penny stock transaction, under Rules 15g-4 and 5. Penny stock purchasers must receive monthly statements disclosing the market value of their penny stock holdings, under Rule 15g-6. See NTM 92-38 (July 1992).[9]

Certain penny stock transactions are exempt from the Disclosure Rules. Rule 15g-1(e) states that "[t]ransactions that are not recommended by the broker or dealer" are exempt from the Penny Stock Rules. Commonly referred to as the "non-recommended" exception, Rule 15g-1(e) "is limited to situations in which a broker-dealer acts as an order taker for the customer, with little or no incentive to engage in manipulative sales tactics." Exchange Act. Rel. No. 34-30608 (Apr. 28, 1992). Thus, the non-recommended exception does not apply when a representative brings a penny stock to a customer's attention because this action is usually intended by a representative, and understood by the customer, as an implicit recommendation to buy the penny stock. Id.

The proper scope and application of Rule 15g-1(e) is the central penny stock issue that this case presents. Respondents concede that they engaged in penny stock transactions with their customers, and that they failed to make the disclosures required by Rules 15g-2 through 6. They claim, however, that the transactions were non-recommended because each time La Jolla's employees sold a penny stock to a customer of the Firm, they obtained a letter, signed by the customer, verifying that the transaction was "unsolicited." Respondents also claim that they satisfied their respective duties of supervision over the Firm's penny stock business by requiring registered representatives to obtain these so-called "Unsolicited Transaction Letters," and by monitoring compliance with that requirement. As set forth more fully below, we conclude that the Respondents' use of the Unsolicited Transaction Letters was not a legitimate effort to comply with the substance of the Penny Stock Rules. Rather, it was a maneuver designed to circumvent those rules while providing the Firm with a superficial paper trail to protect it in the event of an investigation.

II. EVIDENTIARY ISSUES

During the DBCC's 17-day hearing, the staff of District No. 2 ("Staff") introduced more than 200 exhibits and called 53 witnesses to testify.[10] The Staff offered into evidence customer

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[9] Rule 15g-9, also a penny stock rule, requires firms to complete and maintain a written suitability statement prior to effecting a penny stock transaction with a non-established customer.

[10] The Staff called as witnesses four examiners and three La Jolla employees, settling respondents Corey Singman and Gerald Seroy, and Arthur Berry, Gallison's assistant in La Jolla's

questionnaires and declarations of customers from each La Jolla office, many of whom did not testify at the DBCC hearing. In the early stage of its investigation, the Staff sent questionnaires to more than 100 La Jolla customers asking them to describe the circumstances of the penny stock purchases they had made through La Jolla during the relevant period. A cover letter accompanied each questionnaire, warning recipients that NASD Regulation's inquiry "should not be construed as an indication that any violations of the Association's rules have occurred by the member." After receiving the completed customer questionnaires, a Staff examiner drafted a declaration purporting to summarize the circumstances of a customer's penny stock purchase, and then sent the declaration to the customer for signature.

The questionnaires and declarations are hearsay evidence because they are out of court statements that are being used to establish the truth of the statements that they contain. The parties agree that hearsay statements may be admitted as evidence and may, under certain conditions, form the sole basis for findings of fact. See In re Henry E. Vale, Exchange Act Rel. No. 34-35872 (June 20, 1995); In re Robert A. Amato, 51 S.E.C. 316 (1993); In re Dillon Securities Corp., 51 S.E.C. 142 (1993); In re Mark J. Hankoff, 50 S.E.C. 339 (1992).

The DBCC Hearing Panel admitted into evidence: (1) all of the customer questionnaires; (2) the declaration of any customer that testified; and (3) the declarations of all customers of the New York Office, whether or not they testified. In its decision, however, the DBCC gave no weight to the customer declarations because they were tainted by the Staff examiners' "questionable methodology." Several of the declarations are strikingly inconsistent with the questionnaires or testimony of the customers who signed them. The inconsistencies show a bias in the Staff's favor, often regarding critical elements of the case. The DBCC correctly decided that they are unreliable as a group. Accordingly, we conclude that the declarations should be excluded from the record.

Respondents contend that the customer questionnaires also should have been excluded from evidence because they are hearsay and also unreliable. The five factors employed to assess the reliability of hearsay are: (1) whether the hearsay is corroborated; (2) whether direct testimony is contradictory; (3) possible bias of the declarant; (4) the type of hearsay at issue; and (5) whether the missing declarant was available to testify. In re Gary Greenberg, Exchange Act Rel. No. 28076 (1990). Respondents' counsel argue that the questionnaires should be excluded or, if admitted, given little weight because: (1) they are unsworn; (2) the Staff has made no showing that the customers who completed them were unavailable to testify; and (3) some of the questionnaires lack sufficient detail to reconstruct a particular transaction.

We hold that the questionnaires are admissible as a group, but that they must be individually analyzed to determine their probative value. Customer questionnaires are "a necessary and appropriate means of gathering information on members' sales practices" that "furthers the NASD's regulatory objectives." In re Robert A. Amato, 51 S.E.C. 316, 320 (1993).

Trading Department. In addition, 46 customers testified about penny stock purchases they made through La Jolla. The Respondents called no witnesses.

The questionnaires were not tainted by the Staff's improper methodology, as were the declarations. Although sworn questionnaires are more persuasive than unsworn ones, the unsworn questionnaires are corroborated by substantial testimonial and documentary evidence, and also by each other. To the extent that individual questionnaires are deficient, they will receive less weight in determining liability. We find that the customer questionnaires demonstrate sufficient indicia of reliability to be admitted into evidence.

III. DISCUSSION

With this background in mind, we turn to the allegations of the complaint. The decision will address each cause of action separately, setting forth the relevant facts, the applicable legal standards, and the application of the legal standard to the relevant facts.

A. Cause One

The underlying facts are largely undisputed. The Respondents have stipulated that between January 1994 and May 1995, registered personnel in five La Jolla offices effected 268 transactions in 15 penny stocks for which La Jolla was a market maker. These, the "Penny Stock Transactions," occurred as follows: 85 purchases totaling $189,763.70 at the Main Office; 95 purchases totaling $289,310 at the Bethesda Office; 67 purchases totaling $161,752 at the New York Office; 13 purchases totaling approximately $30,756.75 at the Las Vegas Office; and eight purchases totaling approximately $13,000 at the Modesto Office. Respondents have also stipulated that the stocks in question are penny stocks under Rule 3a51-1, and that none of the customers involved received the disclosures required by Rule 15g. The stipulations establish the prima facie elements of violations of the Penny Stock Rules, but two questions remain: (1) how many of these transactions are exempt from the Penny Stock Rules under Rule 15g-1(e); and (2) who is responsible for the violations.

1. Effect Of The Unsolicited Transactions Letters

The Respondents bear the burden of proving that the transactions are exempt under Rule 15g-1(e). In re Kochcapital, Inc., 51 S.E.C. 241 (1992). The Respondents argue that the Penny Stock Transactions are exempt from the Disclosure Rules under Rule 15g-1(e) because, before executing any penny stock transaction, La Jolla required the penny stock purchaser to sign an "Unsolicited Transaction Letter" acknowledging that the transaction was unsolicited. Typically, the Unsolicited Transaction Letter contained the following language:

> All previous and future transactions in the stock(s) listed below have been UNSOLICITED in the past and will continue to be UNSOLICITED in the future. I perform my own due diligence and make my own investment decisions without the advice or recommendations of my La Jolla Capital Corp. broker when dealing with these particular securities. I know and understand I run the real risk of losing part or all of any investment I make in a low-priced security. I have the financial resources to assume such a risk.

The Unsolicited Transaction Letter was periodically refined, but throughout the relevant time period it remained the Firm's sole vehicle for complying with the Penny Stock Rules.

The Staff claims that the Unsolicited Transaction Letters, by themselves, cannot establish that the transactions were exempt because Rule 15g-1(e) applies to "non-recommended" transactions, rather than to "unsolicited" ones. The Staff correctly notes that a transaction that is unsolicited can, nevertheless, be recommended. When the Commission adopted the Penny Stock Rules, it rejected the suggestion of two commenters that the 15g-1(e) exemption should apply to unsolicited, rather than to non-recommended, transactions:

> ... the exemption is limited to situations in which a broker-dealer acts as an order taker for the customer, with little or no incentive to engage in manipulative sales tactics. The rule does not exempt situations in which a broker-dealer brings a penny stock to the attention of an investor because, in most cases, this action is intended, and is understood by the customer, as an implicit recommendation to buy the penny stock.

Exchange Act Rel. No. 34-30608 (April 28, 1992). The Staff argues that the Commission reiterated this distinction in <u>Kochcapital.</u> There the Commission held that order tickets marked "unsolicited" were insufficient to establish that penny stock transactions were exempt under 15g-1(e), because the order tickets were silent on whether the securities had been recommended.

In this case, however, the difference between non-recommended and unsolicited is largely linguistic. The crux of the exemption is that representatives must not advise their clients, either explicitly or implicitly, regarding a penny stock transaction; they must act as mere order takers. The Unsolicited Transaction Letter states not only that the transactions are unsolicited, but also that the customer is acting "without the advice or recommendations" of La Jolla's personnel. If the client acted without a representative's advice or recommendation, the transaction is exempt, regardless of whether the letter is titled "unsolicited" as opposed to "non-recommended." Conversely, representatives may not recommend penny stocks simply because a customer initiates contact.

2. <u>The Penny Stock Rule Violations</u>

Substantial evidence indicates that many of the allegedly unsolicited transactions were, in fact, recommended. Dozens of customers testified, in person or by telephone, that they signed Unsolicited Transaction Letters although their purchases had been recommended by La Jolla personnel. Gerald Seroy and Corey Singman, former La Jolla employees, testified that they recommended penny stock purchases and then obtained Unsolicited Transaction Letters from the purchasers. Numerous customer questionnaires corroborated this testimony.

The testimony and questionnaires reveal several patterns of misconduct by La Jolla representatives: (1) customers received advice from a La Jolla representative, but were told that the Unsolicited Transaction Letter was a "formality"; (2) a transaction was recommended, but the customer was told that the Unsolicited Transaction Letter was a prerequisite to buying the stock; (3) customers contacted a La Jolla office in response to a radio lead-generation program in which a La Jolla registered representative participated, and during which the firm's telephone number was offered; and (4) customers' signatures were forged or replicated without their authorization.

Violations stemming from the Respondents' participation in radio lead-generation programs are particularly troubling. The managers of La Jolla's New York and Bethesda Offices both participated in a radio lead-generation program called "The Next Hot Stock," where they discussed penny stocks in which La Jolla made a market. In each case, they gave the audience the telephone number either of the La Jolla office or of the issuer to call for further information. Knight told the registered representatives in La Jolla's New York Office that leads from the radio show would come in and "we were to persuade [the callers] to buy stock," and that if a person called into the Firm, the subsequent penny stock purchase would be unsolicited. Registered persons in the Bethesda Office also considered these transactions to be unsolicited and, therefore, exempt from the Penny Stock Rules.

The radio lead-generation programs generated substantial penny stock business for the Firm. For example in June and July of 1994, Knight recommended on the radio, InfoServe, Inc. ("InfoServe"), a stock in which La Jolla made a market. In those two months, 28 customers purchased InfoServe from the New York Office. Of those, 20 purchased the stock on the day of or the day after opening their La Jolla accounts, and all but two purchased it within two weeks of opening their accounts. There were an additional 34 purchases of InfoServe under similar conditions during that period at the Bethesda Office. Thus, there were 62 transactions in a single penny stock during a two-month period, and Respondents claim that all of them were non-recommended.

We disagree. Purchases of penny stocks that were made in connection with the radio lead-generation program were recommended and are, therefore, subject to the Penny Stock Rules. There are a limited number of ways these transactions occurred through La Jolla. After listening to the radio presentation the customer could, (1) call the Firm and purchase the stock; (2) call the Firm for further information and then purchase the stock; or (3) call the issuer for further information, and then call La Jolla to purchase the stock. The evidence shows that, in all three cases, the recommendations made during the lead-generation program were reinforced when the customers called La Jolla or the issuer for further information, and when they called La Jolla to purchase the stock.

The customer testimony and questionnaires so often and so thoroughly contradict the Unsolicited Transaction Letters, that the Letters must be considered unreliable as a group. Thus, where customer testimony or questionnaires contradict an Unsolicited Transaction Letter, the Unsolicited Transaction Letter is insufficient to establish that the subject transaction is exempt from the Penny Stock Rules. Based upon these parameters and our review of the evidence, we conclude that for 146 of the 268 Penny Stock Transactions, the Unsolicited Transaction Letters do not establish an exemption from the Penny Stock Rules. These transactions occurred as follows: 43 purchases totaling $99,614 in the New York Office; 63 purchases totaling $201,340 in the Bethesda Office; 27 transactions totaling $60,681 in the Main Office; and 13 transactions totaling $30,756 in the Las Vegas Office.[11]

The evidence was insufficient to establish any violations in the Modesto Office, the single-person office of supervisory jurisdiction run by Budke. The Staff presented no customer testimony that Budke recommended the eight penny stock purchases that he effected at the Modesto Office.

The Staff did introduce three customer questionnaires. One states that Budke neither advised nor encouraged her to buy the stock in question. The other two questionnaires indicate that Budke recommended the purchase of penny stocks, but Budke adamantly denies doing so.

The Staff attempted to bolster the customer questionnaires with the following circumstantial evidence: (1) Budke published a newsletter in which he discussed a penny stock that several La Jolla customers purchased; (2) Budke misunderstood the non-recommended exemption from the Penny Stock Rules; (3) Budke was "enthusiastic" about one penny stock, had had prior dealings with the issuer's president, and had suggested that La Jolla make a market in the issuer's stock; and (4) Budke referred customers to the issuer's management for more information about the stock. These facts might, in certain circumstances, support an inference that Budke recommended the transactions in question, but not in the absence of live customer testimony and in the face of Budke's otherwise uncontroverted denials.[12]

Having found the evidence insufficient to prove any violations by Budke, we dismiss all allegations against him and eliminate all sanctions imposed against him.

3. La Jolla And Gallison Are Responsible For All Of The Violations.

Gallison and La Jolla are responsible for the widespread violations for several reasons. Gallison was intimately involved in every aspect of the Firm's penny stock business. He developed and controlled the Firm's penny stock trading policies and practices. The only credible explanation for La Jolla's blanket use of the Unsolicited Transaction Letters was to avoid ever

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[11] Schedule A to the Complaint, lines 1, 2, 4, 15, 22, 30, 34, 39, 40, 44-47, 49-51, 56, 57, 62, 66, 71, 73, 74-78; Schedule B to the Complaint, lines 1-8, 10-20, 23, 26, 28-38, 41-49, 51-66, 68, 70- 71, 79, 83, 84, 91; Schedule C to the Complaint, lines 1, 4, 6, 7, 9, 10, 12-17, 21, 23-39, 41, 43, 47, 49, 52-54, 56, 58, 60, 62, 63; Schedule D to the Complaint, lines 1-13.

[12] There is no evidence that these customers received Budke's newsletter. The DBCC presumed that because Budke considered a trade to be unsolicited if a customer called him and "brought up" the stock, that he also considered the trade to be non-recommended. There is no evidence that Budke's misunderstanding of the rule extended this far and, in any event, it is no violation to simply misunderstand a rule.

making the disclosure that Congress demanded penny stock purchasers to receive. Gallison and La Jolla stipulated that in no case under investigation did a customer receive complete disclosure under the Penny Stock Rules. Having created the Unsolicited Transaction Letter and designed the mechanism to circumvent the primary obligation under the Rules, Gallison is responsible for the consequences of that circumvention.

Gallison is also responsible as the Firm's head trader and market maker. Gallison made markets in each penny stock underlying each violation that the Firm's representatives committed. In fact, 27 violations occurred in the San Diego office where Gallison himself worked. Six San Diego Office customers testified that, despite their Unsolicited Transaction Letters, La Jolla representatives recommended the penny stocks they purchased, and 16 customer questionnaires corroborate that testimony. As the Firm's head of trading, Gallison caused the trades to be executed and was a central link in the chain of events by which the violations occurred.

Again, the radio lead-generation programs are particularly troubling. Gallison knew that the New York and Bethesda Offices were participating in the programs and that the programs were forwarding requests for information about the companies to the Firm's Offices. He testified that in June 1994, the New York Office's phones were "ringing off the hook" with calls from a lead- generation program. As noted above, there were 62 purchases of InfoServe alone during June and July of 1994. Mehlmann's June 1994 New York Branch Audit Report (which Gallison received), specifically noted that office's affiliation with a national financial radio show that generated investor "inquires [sic] and potential clients." Berry also told Gallison that many of the trades were from radio lead-generation programs.

Gallison had no incentive to halt these violations because they supported La Jolla's market making and wholesale activities. Berry testified that when La Jolla agreed to make a market in a particular stock, the issuer would often sell La Jolla a block of shares priced below the bid to sell to La Jolla's retail customers. The Firm's registered personnel would then recommend the stocks on radio shows sponsored by, or in cooperation with, the issuer. If the program broadcast the Firm's telephone number, purchasers would call the Firm directly; if it broadcast the issuer's telephone number, the issuer would refer the customers to the Firm. Finally, Gallison used sales contests to encourage representatives to sell stocks in which La Jolla made markets.

4. Knight Is Responsible For Violations At The New York Office

Knight is also responsible for numerous violations. The complaint alleges that Knight managed the New York Office and that, during his tenure, respondents there recommended 67 purchases of penny stocks without providing the requisite disclosures. As noted above, the evidence establishes that 43 of those transactions were recommended and, thus, not exempt from the Penny Stock Rules. Knight personally committed 10 of those violations, and is responsible for the other 33 violations as well.[13]

Knight claims that he was not the "designated" office manager until November 1995, after the relevant period, because he was not listed as such on La Jolla's Uniform Application For Broker Dealer Registration ("Form BD").[14] This is accurate, but irrelevant. The question is whether Knight had the authority and responsibilities of a manager, and not simply whether he enjoyed the title. The Staff presented substantial evidence that he did: (1) from July to March of 1995 Knight received all or some of the Office's commission overrides; (2) he paid office bills from his bank account called "Chris Knight Broker Payroll Account," which had a federal tax I.D. number; (3) he hired several brokers in April 1994; (4) he signed the office lease; and (5) Knight was listed as the co-manager of the office in the La Jolla Agency Agreement dated March 2, 1994.[15]

La Jolla personnel at all levels considered Knight to be the manager of the New York Office during the relevant period. In his June 1994 New York audit report, Mehlmann, the National Branch Compliance Officer, listed Knight as the owner and principal of the Office. Gallison testified that he considered Knight to be a co-manager of the New York office. Gerald Seroy, a former registered person under Knight's supervision, testified that Knight had hired him and that Knight ran the office. The DBCC, after assessing Knight's testimony and demeanor, concluded that Knight's denials were not credible.[16] We agree, and conclude that Knight was a manager of the New York Office during the relevant period.

Knight's conduct, as much as his title, makes him liable for the violations at the New York Office. Knight encouraged representatives under his supervision to recommend penny stocks to their customers. Knight participated in the radio lead-generation program, where he discussed penny stocks that La Jolla's customers purchased. Knight told Seroy that leads from the radio show would come in and "we were to persuade [the callers] to buy stock." He also told Seroy that, if a person called into the firm, the subsequent penny stock purchase would be "unsolicited." Thus, Knight not only knew that associated persons were recommending penny stocks to customers, but he also told them to do it.

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[13] Knight acted as a principal for his own sales to customers, signing the New Account Form as both Registered Representative and Branch Manager. See Schedule C, lines 4, 6, 7, 9, 10, 12, 14, 17, 21, 23. These 10 transactions totaled $18,868 and generated $854.55 in commissions for Knight's own account.

[14] Knight claims that his brother William managed the New York Office. William was named in the instant complaint, but settled the allegations against him.

[15] We reject Knight's claims that the commission runs are mistaken.

[16] The Respondents offer no evidence or argument sufficient to disturb the DBCC's credibility determination. See In re Christopher J. Benz, Exchange Act Rel. No 38440 (Mar. 26, 1997); In re Frank. J. Custable, 51 S.E.C. 643 (1993); In re Robert E. Gibbs, 51 S.E.C. 482 (1993).

Respondents claim that they believed in good faith that the Penny Stock Transactions were exempt due to the use of the Unsolicited Transaction Letters. The evidence does not support their claim. In any event, since there is no scienter requirement for finding violations of the Penny Stock Rules, Respondents' states of mind are relevant only to the imposition of sanctions. In re Franklin N. Wolf, Exchange Act Rel. No. 36523 (Nov. 29, 1995) (genuine but mistaken belief about the nature of a penny stock does not absolve respondent of liability); Kochcapital, supra, at fn. 12 (reasonable belief does not negate violation, but merely goes to possible mitigation of sanctions).

5. Conclusion

Accordingly, we find that La Jolla, Gallison, and Knight violated Conduct Rule 2110 by engaging in penny stock transactions without making the disclosures required under SEC Rules 15g-2 through 15g-6. La Jolla and Gallison are liable for the violations committed at all of the offices, and Knight is responsible for the 10 violations that he personally committed, and also for the 33 violations that the other New York representatives committed while under his supervision.

B. Cause Two - Failure To Supervise

Cause Two alleges that La Jolla, acting through Gallison, Mehlmann and Weaver, violated Conduct Rule 3010 by failing to establish, maintain and enforce written supervisory procedures reasonably designed to detect, deter, or prevent the penny stock violations committed by the Respondents at the Firm's Bethesda, New York, Las Vegas, Modesto, and Main Offices.

Conduct Rule 3010 requires that members establish, maintain, and enforce a supervisory system with written procedures and that these procedures be "reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of [the] Association." The standard of "reasonableness" is determined based on the particular circumstances of each case. In re Christopher Benz, Exchange Act Rel. No. 38440 (Mar. 26, 1997); In re Consolidated Investment Services, Inc., Exchange Act Rel. No. 36687 (Jan. 5, 1996); In re Rita H. Malm, Exchange Act Rel. No. 35000 (Nov. 23, 1994). The burden is on the Staff to show that the Respondents' procedures and conduct were not reasonable. In re Wedbush Securities, Inc., Exchange Act Rel. No. 25504 (May 24, 1988). It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better. In re Arthur James Huff, 48 S.E.C. 767 (1991); In re Louis R. Trujillo, 49 S.E.C. 1106 (1989).

1. The Supervisory Procedures

When Gallison joined La Jolla in 1991, he developed and implemented the Unsolicited Transaction Letter approach to penny stock transactions. Under that approach, penny stock supervision focused on ensuring that each penny stock transaction was exempt from the Penny Stock Rules. At all relevant times, the Firm's supervisory procedures required that registered personnel obtain an Unsolicited Transaction Letter before effecting any penny stock transaction. The Letter was submitted to La Jolla's trading desk along with an order ticket for a penny stock, and the principals at the trading desk, including Gallison, would effect the transaction only if they believed it was exempt from the Penny Stock Rules, as evidenced by the Unsolicited Transaction Letter.

In the Spring of 1994, the Firm began requiring that the Unsolicited Transaction Letter include the customer's telephone number. Gallison changed the policy because he noted increased use of the Unsolicited Transaction Letter in the Firm's New York office.[17] According to Respondents, requiring the customers' telephone numbers would enable the Firm to spot check whether the registered representatives were using unsolicited letters properly, and to deter abuse.

Arthur Berry, Gallison's trading assistant, testified that Gallison did require him to make random calls to customers. Berry understood that the purpose of the calls was to verify that the customer was aware of the trade, that he had signed the Unsolicited Transaction Letter, and that the trade was, in fact, "unsolicited."[18] The calls lasted 30 seconds or less, and Berry did not ask the customers any questions to determine whether the salesperson had recommended the stock or in any way encouraged the purchase. There were no written procedures instructing Berry how to question the customers, or establishing supervision of Berry's spot-checking practice. Berry testified that he called roughly a quarter of the customers who had signed unsolicited letters, which was approximately 25 calls per day. Although the written procedures did not require spot checks until December 1994, Berry began making such calls somewhat earlier.

In January 1995, the Firm changed its penny stock procedures again. The Firm began requiring an employee directly to contact each customer involved in a transaction that invoked the 15g-1(e) exemption. In the Fall of 1994, Gallison and Mehlmann learned of forgeries and other irregularities in the use of Unsolicited Transaction Letters in the New York Office.[19] According to Gallison, wishing to discourage so many unsolicited transactions and to get away from reliance on lead-generation programs, he implemented a new policy that all penny stock trades would be delayed up to 48 hours in order for Berry or a principal to call every customer. The Firm abandoned this policy after just two weeks because salespeople and customers demanded timely trades.

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17 Gallison denied knowing that La Jolla representatives appeared on radio lead-generation programs or that Knight had used La Jolla's name during the broadcasts. Gallison testified that he believed the transactions resulting from these calls were unsolicited and non-recommended. Therefore, he believed that using the Unsolicited Transaction Letter to verify the unsolicited nature of the purchase was appropriate.

18 Berry, himself, testified that he did not believe the orders were all unsolicited. He stated he mentioned to Gallison that a lot of the trades were from radio ads and asked Gallison if these trades were truly unsolicited. According to Berry, Gallison's response was that if the client says the transaction was unsolicited, the Firm would run the trade.

19 The record contains statements from many customers from the New York, Bethesda and Las Vegas Offices, testifying to multiple uses of an unsolicited letter meant for one purchase, unsolicited letters signed in blank and reused, as well as forged signatures on the letters.

Respondents claim that the Firm also began sending its penny stock investors a seven-page disclosure document, whether or not it received an Unsolicited Transaction Letter from them. This document contained some but not all of the disclosures required by the Penny Stock Rules, and some but not all of La Jolla's penny stock customers received the disclosure document. Gallison also testified that the Firm kept a log of all unsolicited transactions, but that log was not offered into evidence.

2. La Jolla and Gallison Violated Conduct Rule 3010

La Jolla and Gallison never made a legitimate attempt to comply with the Penny Stock Rules as a whole. Instead, they crafted procedures that focused on ensuring only that each penny stock order was accompanied by an Unsolicited Transaction Letter, rather than on ensuring compliance with the Penny Stock Rules. Rule 3010(b)(1) requires "procedures to supervise the types of business in which the firm engages ... that are reasonably designed to achieve compliance with applicable securities laws and regulations." La Jolla's procedures carved out a small portion of the securities laws and regulations applicable to penny stock transactions, and ignored the rest. Thus, we disagree with Respondents' claim that they used the Unsolicited Transaction Letters to ensure compliance with a "variety of rules" when claiming that the non-recommended exemption was available in a particular transaction. The Firm devised procedures to comply with one rule and one rule only. It avoided, at all costs, providing its customers with the disclosures that Congress deemed necessary to avoid high-pressure tactics and manipulation. The violations in this case confirm Congress' fears.

La Jolla's procedures were inadequate even with respect to the small area they covered. The Firm did not design reasonable procedures to oversee the salespersons' use of the Unsolicited Transaction Letter. The procedures did not adequately explain that, to be exempt from the Penny Stock Rules, penny stock transactions needed to be both unsolicited and non-recommended. There were no procedures in place for educating registered personnel about the difference between those terms. The supervisory manual never correctly defined "non-recommended" transactions, and never properly distinguished between non-recommended and unsolicited transactions. Thus, although we disagree with the DBCC's conclusion that La Jolla actively misled its representatives into violating the Penny Stock Rules, we conclude that La Jolla recklessly failed to educate them about the proper use of the Unsolicited Transaction Letters.

La Jolla claims that it went above and beyond the minimum requirements by instituting procedures for contacting penny stock purchasers. Beginning in the Spring of 1994, La Jolla required registered representatives to include the client's phone number on their Unsolicited Transaction Letters. There is no evidence, however, that the Firm actually spot-checked transactions until much later in the year, relying instead on the threat of detection. Although Gallison did instruct Berry to call customers regarding the Unsolicited Transaction Letters in late-1994, the written procedures contained no instructions about what inquiry was required to ensure that a specific transaction was "non-recommended." There were also no procedures reasonably designed to ensure that the spot-checkers were performing their task properly.[20] Therefore, we find that La Jolla and Gallison's new procedures were not a reasonable response to the problems that they had detected.

The Firm's procedures were also deficient with respect to the layers of supervision within the Firm. Gallison fragmented the Firm's supervision, separating the supervision of La Jolla's penny stock trading from the other aspects of La Jolla's supervisory system. See In re Smith Barney, Harris Upham & Co., Inc., Exchange Act Rel. No. 21813 (March 5, 1985) ("as firms expand their size through the opening of new branch offices ... it is essential that supervisory oversight remain diligent and not be fragmented or dissipated... The need for central control increases, not decreases, as branch offices become more numerous, dispersed and distant."). See also In re Reynolds & Co., 39 S.E.C. 902 (1960) ("The existence of numerous and scattered branch offices complicates the problem of supervision and makes essential the installation of an adequate system of control.").

Although Gallison delegated significant supervisory authority and responsibility to Mehlmann to monitor the Firm's remote offices, he specifically retained control over the penny stock trading practices. Thus, when Mehlmann audited a remote office, he did not evaluate its penny stock transactions, and neither did Gallison. To the extent that Gallison could supervise the Offices' penny stock practices from the Trading Desk in San Diego, that supervision was not coordinated with Mehlmann. Thus, the audit procedure, customer complaint procedure, and penny stock spot checking procedure were all compartmentalized and uncoordinated with each other.

Gallison also failed to establish reasonable procedures to monitor the office managers and for the managers to supervise their registered representatives. Rule 3010(a)(5) requires firms to assign "each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities." It is well-established that "a system of supervisory procedures which rely (sic) solely on the branch manager is insufficient." In re Dickinson, Exchange Act Rel. No. 36338 (Oct. 5, 1995); In re Shearson Lehman Brothers, Inc., Exchange Act Rel. No. 23640 (Sept. 24, 1986). La Jolla was also required to "provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised." In re Mabon, Nugent & Co., 47 S.E.C. 862, 867 (1983). This is particularly troubling where, as here, the offices were distant from La Jolla's headquarters, were owned by the managers, were free to determine their own business mix, and neither the managers nor the representatives received any training from the Firm.

Gallison also ignored numerous red flags that should have alerted him to violations. In re John H. Gutfreund, 51 S.E.C. 93 (1992) (failure to supervise can arise where a supervisor was aware only of "red flags" or "suggestions" of irregularity); In re Michael H. Hume, Exchange Act

[20] Thirty-eight of the 46 testifying customers stated they were not called to confirm their unsolicited letters. Seven of these customers made purchases after January 1, 1995, when every customer was to be contacted The remainder of the customers made purchases during the earlier "spot check" period.

Rel. No. 35608 (April 17, 1995). A broker/dealer must adequately follow up and review a matter when the firm's own procedures detect irregularities or unusual trading activity. See In re Rita H. Malm, Exchange Act Rel. No. 35000 (Nov. 23, 1994). When a supervisor is faced with red flags, especially when the employee in question has no effective line supervisor, the supervisor's duty to follow-up and investigate is heightened. In re Bradford John Titus, Exchange Act Rel. No. 38027 (Dec. 9, 1996).

Among the numerous red flags that Gallison had were: (1) that the New York and Maryland Offices were engaged in radio lead-generation programs regarding penny stocks; (2) that penny stock transactions accounted for a substantial portion of the business at those Offices; (3) that the Firm was processing numerous, clustered transactions in penny stocks for which it made markets; (4) that Unsolicited Transaction Letters had been forged or misused at several of the Firm's offices; and (5) that Knight had engaged in misconduct that was serious enough to warrant a fine and suspension by the Firm.

Gallison attempts to shift the responsibility for these violations to the Commission and to the NASD in two ways: (1) he claims that the Commission and NASD inspected the Firm's procedures and failed to identify any weaknesses regarding penny stock practices; and (2) he also claims that an NASD examiner explicitly approved the Firm's activities regarding Rule 15g. These claims fail because La Jolla cannot shift its compliance responsibilities to the NASD. In re First Inland Securities, Inc. 51 S.E.C. 1086, n. 12 (1994); In re Sherman, Fitzpatrick & Co., Inc., 51 S.E.C. 1048, fn. 8 (1994). See also In re W.N. Whelen & Co., Inc., 50 S.E.C. 282 (1990) (regulatory authority's initial non-action does not estop later action or cure violation); In re Jeffrey D. Field, 51 S.E.C. 1074, fn. 9 (1994) ("Participants in the industry must take responsibility for their compliance with applicable regulatory requirements and cannot be excused for lack of knowledge, understanding or appreciation of these requirements").

Gallison, as President of La Jolla, was responsible for compliance with all of the requirements imposed on La Jolla "unless and until he reasonably delegate[d] particular functions to another person in that firm, and neither [knew] nor had reason to know that such person's performance [was] deficient." Patrick v. SEC, 19 F.3d 66, 69 (2d Cir. 1994); In re Universal Heritage Investments Corp., 47 S.E.C. 839, 845 (1982). Gallison did not delegate penny stock supervision to Mehlmann and, therefore, Gallison remained responsible for the violations that occurred.

Accordingly, we find that La Jolla and Gallison failed to establish, maintain, and enforce procedures reasonably designed to ensure compliance with the Penny Stock Rules in violation of Conduct Rule 3010. We further find that La Jolla and Gallison's conduct failed to satisfy just and equitable principles of trade and high standards of commercial honor required by Conduct Rule 2110.

3. Mehlmann Violated Conduct Rule 3010, But Weaver Did Not

Weaver and Mehlmann argue that they cannot be charged with failure to supervise activity for which they had no supervisory responsibility. They correctly note that whether a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the entity whose behavior is at issue. In re John Gutfreund, 51 S.E.C. 93 (1992). See, In re First Albany Corp., 51 S.E.C. 145 (1992) (firm officials can be responsible for failure to supervise even if they lacked the ability to hire and fire); In re Michael E. Tannenbaum, 47 S.E.C. 703 (1982) (same).

Mehlmann was an influential supervisor at the Firm. The Firm hired Mehlmann in November 1993 to perform a compliance function at La Jolla's troubled Colorado office. In February 1994 he became the Firm's National Branch Compliance Officer, and he assumed responsibility for the Firm's supervisory procedures. Mehlmann reviewed the procedures manual, drafted proposed revisions, obtained Weaver's feedback on the proposals, and then submitted them to Gallison. Gallison retained the authority to approve, modify or reject his recommendations. The Firm's procedures manual was amended through this procedure at least twice in 1994, and then again in 1995.

Mehlmann was also responsible for the Firm's national branch audit program. The Firm's procedures manual required Mehlmann to audit all 13 of La Jolla's offices of supervisory jurisdiction twice per year, to issue detailed audit reports rating various elements of the Offices' performance, and to recommend the imposition of sanctions by the Firm to address violations of applicable rules. As noted earlier, by Gallison's design, Gallison was responsible for supervising penny stock transactions and Mehlmann was not. Although Mehlmann was not required to audit the Offices' penny stock trading or procedures, his audit reports did identify numerous problems with the penny stock trading at various Firm offices: significant penny stock sales in several branches; the use of the lead-generation programs; customer complaints regarding penny stocks; forged customer signatures on the Unsolicited Transaction Letters; and the use of unregistered personnel in the New York Office, which had a significant penny stock business.

Mehlmann claims that he did not violate Conduct Rule 3010 because he had no day-to-day supervisory responsibility for penny stock transactions and because he had no authority to change La Jolla's penny stock supervisory procedures. These claims are irrelevant. Mehlmann had sufficient red flags regarding the Firm's penny stock trading problems that he was required to investigate and follow-up, particularly because he knew that the Firm's registered representatives had no effective line supervisor regarding penny stocks. In re Bradford John Titus, Exchange Act Rel. No. 38027 (Dec. 9, 1996). Although Mehlmann was not specifically charged with supervising penny stock trading, he was required to review and revise all of La Jolla's supervisory procedures, including the penny stock procedures. There is no evidence that Mehlmann took any steps to improve the penny stock procedures; he launched no investigation and drafted no proposed changes.[21] If Mehlmann had taken appropriate steps and Gallison had failed to act, Mehlmann would have a stronger defense. Instead, he did nothing.

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21 The Commission has suggested that non-line supervisors can take many steps to discharge their supervisory responsibilities:

> For example, such a person could direct or monitor an investigation of the conduct at issue, make appropriate recommendations for limiting the activities of the employee or

With respect to Weaver, there is abundant circumstantial evidence of Weaver's prominent status and role at La Jolla. He served La Jolla in numerous capacities, including Chief Legal Counsel, member of the Board of Directors, Executive Vice President, Secretary and Treasurer, general securities principal, and 30 percent shareholder of the Firm. In these varied capacities, Weaver participated in many Firm activities, including attending Firm management meetings, approving new accounts, and filing the Firm's Focus Reports.

There is, however, no direct evidence that Weaver was assigned supervisory responsibility for penny stock sales practices, that he affirmatively assumed such responsibility, or that he knew of the Firm's problems in that area or took affirmative steps to avoid such knowledge. Weaver attended Firm management meetings, but there is no evidence that problems with the penny stock procedures were discussed at those meetings. Nor can we assume that such discussions occurred because the Firm's penny stock business accounted for five percent of its overall business. Weaver had the authority to approve new accounts, but there is no evidence of which new account forms Weaver reviewed or that simply reviewing new account forms did or should have signaled him that problems existed with the Firm's penny stock procedures. Weaver's high status at the Firm and his generalized knowledge of the Firm's operations were insufficient to create a duty to supervise the Firm's penny stock practices.

Similarly, while Weaver played a substantial role in developing and implementing the Firm's penny stock procedures, there is no evidence that this role continued into the period covered by this complaint. When the Commission changed the Penny Stock Rules in 1992, Weaver analyzed the new rules, attended an NASD information session regarding those rules, and helped Gallison draft the Firm's new penny stock procedures. There is no evidence, however, that the Firm's supervisory manual ever delegated supervisory duties to Weaver and, although Gallison asked Weaver to review Mehlmann's proposed modifications to the Firm's supervisory procedures, there is no evidence that Mehlmann told Weaver about the problems with the Firm's penny stock trading or otherwise indicated to Weaver that problems existed. Weaver's early involvement in drafting the Firm's penny stock procedures, by itself, did not create an open-ended obligation for him to supervise penny stock sales practices.

Thus, although the DBCC may have been correct in noting that Weaver is a knowledgeable and competent individual, that he had a financial incentive to understand the Firm's business, and that he served the Firm in a multitude of capacities, we find that the particular facts and circumstances described above did not create a duty that Weaver supervise the Firm's penny stock sales practices.

> for the institution of appropriate procedures, reasonably designed to prevent and detect future misconduct, and verify that his or her recommendations, or acceptable alternatives, are accepted. ... Once a person has supervisory responsibilities by virtue of the circumstances of a particular situation, he must either discharge those responsibilities or know that others are taking appropriate action.

In re John H. Gutfreund, 51 S.E.C. 93 (1992).

Accordingly, we find that Mehlmann failed to establish, maintain and enforce supervisory procedures reasonably designed to detect and deter violations of the Penny Stock Rules in violation of Conduct Rule 3010, and that Mehlmann violated just and equitable principles of trade and the high standards of commercial honor that Conduct Rule 2110 demands. We further find that the allegations against Weaver should be and, hereby are, dismissed.

4. Knight Violated Conduct Rule 3010

Knight's only defense to the failure to supervise charge is that he was not the "designated" supervisor of the New York Office. We reject that defense, as we rejected it with respect to Cause One. The Staff introduced substantial evidence that Knight could affect the conduct of the registered representatives at the New York Office. Despite the lack of the title of manager, Knight hired representatives, received commission overrides, signed the office lease, and paid office expenses. The fact that he was not designated as the office manager on La Jolla's Form BD is irrelevant in light of Knight's supervisory responsibilities.

Knight does not dispute that he failed to supervise the representatives at La Jolla's New York Office. The evidence establishes that Knight took no steps to monitor the representatives' compliance with the Penny Stock Rules, that he took no steps to investigate the numerous red flags signaling violations of the Penny Stock Rules, and that he took no steps to deter future misconduct. Accordingly, we find that he failed to supervise the registered representatives who engaged in the violative penny stock transactions in the New York Office. We find that Knight's conduct violated Conduct Rules 2110 and 3010.

C. Cause Five - Knight Violated Membership and Registration Rule 1031

Cause Five alleges that from March 24, 1994 through January 17, 1995, Knight permitted three unregistered persons whom he supervised to engage in the securities business by soliciting investors to purchase penny stocks and by accepting customer orders. This conduct is alleged to have violated Membership and Registration Rule 1031(a) (formerly Part III, Section 1(a) of Schedule C to the By-Laws).

Rule 1031(a) requires that "[a]ll persons engaged or to be engaged in the investment banking or securities business of a member who are to function as representatives shall be registered as such with the Corporation in the category of registration appropriate to the function to be performed." Section 1(b) defines "representatives" as "[p]ersons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions." Article I (k) of the NASD's By-Laws provides that "investment banking or securities business" means the business of "underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others."

The individuals in question were required to register because they performed the functions of a representative. Functions performed by representatives include, but are not limited to, communicating with members of the public to determine their interest in making investments, discussing the nature or details of particular securities or investment vehicles, recommending the purchase or sale of securities, and accepting or executing orders for the purchase or sale of securities. See NTM 85-48 (July 1985) (personnel who solicit new accounts by telephone must register); NTM 88-24 (Mar. 1988) (personnel who accept orders from customers must register); and NTM 88-50 (July 1988) (personnel who make "cold-calls" must register).

At least three individuals engaged in the securities business in the New York Office without the benefit of registration. Seven customers testified and eight customers submitted questionnaires stating that salespeople named "Dzurko," "Rosani," and "Anderson" had recommended penny stocks to them prior to January 17, 1995. Michael Dzurko was associated with La Jolla from April to December of 1994, without registering in any capacity during that time. Frank Rossani became associated with La Jolla in March of 1994, but did not pass the Series 7 examination until April of 1995. Between June and December of 1994, Nigel Anderson was associated with La Jolla without registering. Anderson had been associated with Burnett Grey, the predecessor to La Jolla's New York Office, from January through March of 1994.

Knight was aware that non-registered individuals were prohibited from engaging in the securities business at La Jolla's offices because he had been fined and suspended by the Firm for that very conduct. On October 31, 1994, Mehlmann alerted Knight and Knight's brother that "trade problems" had occurred in accounts opened for Knight by an individual whose registration was pending approval. Mehlmann warned Knight that "[t]he office needs to make sure that only recognized and approved brokers are permitted in the office and allowed to contact clients," citing the Firm's Policy No. 3045. Mehlmann and Gallison fined Knight $2,500 and restricted him from all supervisory responsibilities for 60 days. Knight signed the letter.

Knight claims that he is not responsible for the registration violations because: (1) the unregistered individual only filed papers and "answer[ed] telephones when there was no one else available due to the large number of radio call-ins";[22] (2) he had no knowledge of an unregistered individual effecting securities transactions; and (3) he was not a supervisor. Knight's claims are meritless. As noted above, associated persons who regularly respond to telephone inquiries are required to register. The DBCC rejected Knight's claims of ignorance, finding his credibility to be "suspect in every respect," and we will not disturb its credibility determination. Finally, Knight was a supervisor at the New York Office and, as such, is responsible for the violations.

Accordingly, we find that Knight violated Conduct Rule 2110 and Membership and Registration Rule 1031 by permitting unregistered individuals to engage in the securities business, as alleged in Cause Five of the complaint.

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[22] In essence, Knight is claiming that using unregistered personnel was excusable because all of the registered people were busy.

IV. PROCEDURAL ISSUES

Respondents claim that they were denied due process during the investigatory and adjudicatory phases of the case. Respondents are entitled to receive the core elements of due process in an administrative forum, i.e, an opportunity to be heard at a "meaningful time and in a meaningful manner." Matthews v. Eldridge, 424 U.S. 319 (1976). In applying these requirements, the courts have held that self-regulatory organization disciplinary proceedings must comply with fundamental standards of fair play. See Crimmins v. American Stock Exchange, 346 F. Supp. 1256 (S.D.N.Y. 1972). Substantial weight has also been accorded to "the good faith judgments of agency decision makers to determine which procedures are appropriate to insure a fair hearing." Gibbs v. SEC, unpublished opinion, 25 F.3d 1056 (10th Cir. 1994). The record establishes that Respondents were afforded the process to which they were entitled.

A. Composition Of The DBCC Hearing Panel

Respondents challenge the composition of the DBCC hearing panel following the mid-hearing recusal of panel member and attorney, Jerry M. Gluck ("Gluck"). The panel was originally composed of Gluck and two other individuals. At the start of the hearing, Gluck disclosed to the other two panel members and to the parties that his son was an examiner trainee in the NASD's District 10 office. Respondents did not object to Gluck's participation in the hearing.

During the 12th day of the hearing, Gluck disclosed that his son had accepted an examiner position with the District No. 2 office. Respondents immediately objected to Gluck's continued participation and requested that the hearing be adjourned and a new panel appointed. Respondents made three arguments: (1) the issues presented by the case are complicated and require a hearing panel that includes an attorney; (2) they are entitled to a three-member hearing panel; and (3) that the remaining panelists were unduly influenced by Gluck, who had forcefully questioned several of the Staff's witnesses. The remaining two panelists deliberated about these issues -- without Gluck's participation. They agreed that Gluck should not participate further, but they refused to terminate the hearing. The remaining panelists reasoned that Procedural Rule 9223 (a) requires only a two- person hearing panel, that they had an NASD Attorney Advisor to assist with complicated legal issues, and that they had not been influenced by Gluck's participation.

We reject Respondents' renewed objections to the DBCC panel members' decision to continue the hearing after Gluck's departure. NASD Procedural Rule 9223(1) provides that "the entire District Business Committee may sit as a hearing panel, or it may appoint a hearing panel of two or more persons, all of whom are associated with members of the Corporation, at least one of whom shall also be a member of the District Business Conduct Committee unless otherwise directed by the National Business Conduct Committee." (emphasis added). Respondents did not have a right to have an attorney sit on the hearing panel. In re Thomas R. Alton, Exchange Act Rel. No. 36058 (Aug. 4. 1995) (rejecting same challenge), aff'd, 94-16589

(9th Cir. 1996) (unpublished opinion). Nor were they entitled to a three-person hearing panel. In re Keith L. DeSanto Exchange Act Rel. No. 35860 (June 19, 1995), aff'd, 101 F. 3d 108 (2d Cir. 1996) (table). The Panel was duly constituted under Procedural Rule 9223(a).

Respondents cannot establish any prejudice resulting from Gluck's recusal, particularly in light of the availability of DBCC review and de novo appellate review. See In re Curtis I. Wilson, Exchange Act Rel. No. 26425 (Jan. 6, 1989), aff'd sub nom., Wilson v. SEC, 902 F.2nd 1580 (9^{th} Cir. 1990). There is no evidence that Respondents requested or expected either a three-member panel or that the panel include a lawyer. It is standard for the DBCC to appoint a three-member panel in a case of this magnitude, but there is no entitlement to such a panel. In fact, the possibility of a recusal or withdrawal is a primary reason for appointing a three-member panel. A rule requiring a new hearing whenever a panel member is recused would place an unwarranted burden on the disciplinary process.

Respondents have presented no evidence of actual bias or prejudice as a result of Gluck's initial participation or his later removal. There is no evidence in the record that the panelists who decided the case -- without Gluck's participation -- were biased. Nor is there evidence that they were unduly influenced by Gluck's participation, or that Gluck's questioning of witnesses was inappropriate or motivated by bias. See In re Brooklyn Capital & Securities Trading, Inc., Exchange Act Rel. No. 38454 (Mar. 31, 1997) (panel member's questions were directed at clarifying witness' answers); In re U.S. Securities Clearing Corp, Exchange Act Rel. No. 35066 (Dec. 8, 1994) (same); In re Michael A. Leeds 51 S.E.C. 500, 506 (1993) (panel has right to question witness to elicit testimony). There is no evidence of prejudice from the lack of an attorney on the DBCC panel; the remaining panelists had available the legal expertise of an attorney advisor from an outside NASD office. Finally, there is no evidence of prejudice against Respondents based on retaliation for their request for a new hearing panel. Unsubstantiated assertions of bias are an insufficient basis to invalidate NASD Regulation proceedings. See In re Rita H. Malm, Exchange Act Rel. No. 35000 (Nov. 23, 1994); In re David A. Gingras, 51 S.E.C. 622 (1992); In re Cal Caulfield & Co., 48 S.E.C. 452 (1986); In re Robert E. Gibbs, 51 S.E.C. 1131 (1993); In re Arthur J. Lewis, 50 S.E.C. 1487, 1489 (1991).

Accordingly, Respondents' challenges to the composition of the DBCC hearing panel are rejected.

B. Staff Conduct

Respondents allege that the Staff acted improperly during three phases of this case. First, Respondents contend that the staff examiners acted improperly during their examination of La Jolla by failing to conduct an exit interview, failing to give the Respondents notice that an investigation was under consideration, and failing to inform one individual, who was later named as a respondent, that he had the right to counsel during the examination. These arguments are without merit. Even assuming that their allegations are correct, Respondents did not have the right to either an exit interview or notice that an investigation was under consideration. Nor did Respondents have a constitutional or statutory right to counsel in NASD Regulation disciplinary proceedings, In re Falcon Trading Group, Ltd., Exchange Act Rel. No. 36619 (Dec. 21, 1995); In re Phyllis J. Elliott, 51 S.E.C. 991, 996 (1994); In re Richard R. Perkins, 51 S.E.C. 380, 386 (1993), and there is no policy justification for granting such a right to counsel during an examination.

Second, Respondents allege that the Staff acted improperly during the investigatory phase of the case by refusing to produce the examiners' work papers and by misstating customer communications in the declarations that the examiners drafted for the customers to sign. Respondents had no right to discover the NASD's investigatory materials. In re Patten Securities Corp., 51 S.E.C. 568, 578 (1993) (respondents have no right to probe NASD's decision-making process); In re Steven B. Theys, 51 S.E.C. 473, 481, n. 23 (1993) (respondents are not entitled to discover investigatory reports); In re David R. Esco, Jr., 46 S.E.C. 1205, 1207, n. 7 (1978) (same). The alleged bias of an NASD investigator is insufficient to invalidate an entire decision. In re Frank J. Custable, 51 S.E.C. 643, 650 (1993). In any event, Respondents suffered no prejudice because the allegedly tainted declarations have been excluded from evidence.[23]

Third, Respondents argue that, during the DBCC hearing, District Director, Lani Woltman ("Woltman"), improperly influenced the proceedings and caused the hearing panel to modify an earlier ruling in a manner that was adverse to the Respondents. Respondents have presented no direct evidence to establish that Woltman acted improperly, and the staff denies the Respondents' allegation. In any event, Respondents cannot show that Woltman's allegedly improper influence prejudiced them; the full District Committee ultimately adopted the Hearing Panel's initial ruling, and we uphold that initial ruling after an independent review of the record. See In re David A. Gingras, 51 S.E.C. 622 (1992) (prejudice cured by independent review of the record); In re Charles L. Campbell, 49 S.E.C. 1047 (1989) (same).

Finally, Respondents allege that this disciplinary proceeding was motivated by the NASD's animus toward firms that deal in penny stocks. No showing of selective prosecution has been made. To establish selective prosecution, one must show both that he was singled out for enforcement action while others similarly situated were not, and that the action was motivated by arbitrary or unjust considerations, such as race, religion or the desire to prevent the exercise of a constitutionally-protected right. U.S. v. Huff, 959 F.2d 731 (8th Cir. 1992); C.E. Carlson, Inc. v. S.E.C., 859 F.2d 1429, 1437 (10th Cir. 1988). Neither showing has been made here.[24]

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[23] Respondents' counsel very capably and effectively cross-examined the testifying witnesses, utilizing their questionnaires and declarations. In fact, on the basis of Respondents' cross examination, the Panel determined that the methodology used by staff in obtaining information for and creating customer declarations was flawed and of questionable reliability.

[24] During oral argument on appeal, counsel for Respondents alleged that a newspsaper article cited officials of NASD Regulation describing this case as a vehicle by which the organization was "going to make its presence felt in the penny stock area." Tr. p. 17. This newspaper article was not part of the record on appeal and, therefore, we cannot consider it.

V. SANCTIONS

Respondents claim that the sanctions that the DBCC imposed are excessive. "[T]he question of whether disciplinary action is excessive depends on the particular facts of each case and cannot be determined with any exactness by comparison with the action taken in other cases." In re Donald W. Collins, 46 S.E.C. 642, 647 (1976); See also, In re Jeffrey D. Field, 51 S.E.C. 1074, 1077 (1994). The imposition of a sanction is within the authority of an administrative agency and thus is not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases or against other individuals in the same proceeding. Butz v. Glover Livestock Commission Co., 411 U.S. 182, 187 (1973), reh'g denied, 412 U.S. 933 (1973); Hiller v. SEC, 429 F. 2d 856, 858-859 (2d Cir. 1970). See also In re Robert A. Amato, 51 S.E.C. 316, 321 (1993), aff'd, 18 F.3d 1281 (5th Cir. 1994), cert. denied, 115 S.Ct. 316 (1994).

This section of the decision will assess the sanctions to be imposed for each cause of action, beginning with the applicable Sanction Guideline, and followed by an analysis of the principal considerations. The Sanction Guidelines "do not specify required sanctions but merely provide a 'starting point' in the determination of remedial sanctions." In re Hattier, Sanford & Reynoir, et al., Exchange Act Rel. No. 39543, at 9 n.17 (Jan. 13, 1998) (quoting In re Peter C. Bucchieri, Exchange Act Rel. No. 37218 (May 14, 1996)).

A. Penny Stock Violations

The applicable Sanctions Guideline for violations of the Penny Stock Rules suggests a fine of $2,500 to $20,000 in routine cases, and a fine of $2,000 per violation plus fining away all remuneration for willful violations.[25] In egregious cases the Guideline suggests requiring that the firm offer recission to any customers still holding the penny stocks. In addition, the Guideline recommends the imposition of non-monetary sanctions as follows: first time offenders may be suspended from recommending penny stocks for one year and, for willful violations, a longer suspension from penny stock transactions or a suspension in all capacities. In egregious cases, the Guideline suggests considering expelling the firm.

The principal considerations for determining what sanctions within the recommended range are appropriate are: (1) prior or other similar misconduct (e.g., unsuitable transactions); (2) deliberate attempt to circumvent rule (i.e., capricious claims of exemption; misleading customers regarding Rule requirement); (3) dollar amount of improper transactions, amount of commissions, mark-ups, or other benefits to firm or associated persons based on improper transactions; (4) nature of violations based on: ... (B) wrongly claimed "non-recommended" transactions; (5) number of violative transactions; (6) knowledge, participation, and involvement of registered representative in handling of violative transaction; (7) lack of appropriate written supervisory procedures and other compliance efforts; (8) extent of harm or injury to customers;

[25] See Sanctions Guidelines (1993 ed.) at 32 (Penny Stock Rules Violations).

(9) mistaken understanding of requirements followed by prompt voluntary restitution or recission by the respondent; and (10) other mitigating or aggravating factors.

Applying these factors reveals that the violations in this case were willful and support the imposition of a $2,000 fine per violation. As noted above, La Jolla and Gallison knowingly used the Unsolicited Transaction Letter to circumvent the protections at the heart of the Penny Stock Rules. The evidence shows that La Jolla's representatives abused the Unsolicited Transaction Letters, misled their customers regarding the Rules' requirements, and made false and unsubstantiated claims of exemption. The violations occurred on a vast scale and involved a large dollar amount of improper transactions: 148 transactions involving $399,321. In addition to the actual commissions earned by the Firm and its representatives, La Jolla also benefitted in an unquantified amount, by being a market maker in the penny stocks at issue and by receiving stock at prices below the bid for sale to retail customers. The knowledge, participation, and involvement of La Jolla's registered representatives in handling the violative transactions extended to all levels of the Firm's hierarchy. There are no mitigating factors present.

Accordingly, La Jolla and Gallison are fined $2,000 for each of the 146 violative transactions, $292,000, plus the $5,380 payout to the Firm from the violative transactions, for a total fine of $297,380. The fine is imposed jointly and severally.

In addition, La Jolla and Gallison are barred from participating in penny stock sales or promotion in any capacity. La Jolla and Gallison are also required to offer either restitution or recission to the customers involved in the violative transaction identified in our findings; if customers hold the stock in question, they must receive an offer of recission, and if they no longer hold the stock, they must receive restitution for any losses they suffered in connection with the purchase of the stock.[26]

Knight is fined $20,854.55, which equals $2,000 for each violation that he personally committed, plus $854 in commissions that Knight earned through these transactions. Knight is also barred from participating in penny stock sales or promotion in any capacity.

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[26] The Firm and Gallison first shall present an accounting of the customers entitled to recission and a copy of a draft letter offering recission to the customers, to the Staff within 45 days from the date of the final decision in this matter. Within 30 days from the date of the approval by the Staff of the documentation and draft letter, the Firm and Gallison shall present proof of receipt by the identified customer or attempted delivery of the offer of restitution or recission to each identified customer to the Staff. They shall then provide proof of receipt by identified customers or attempt to deliver such restitution to identified customers within 30 days of approval of the accounting and transmittal letter by the Staff.

B. Supervision Violations

The applicable NASD Sanction Guideline recommends individual fines against the firm and the responsible principal of up to $25,000 in routine cases but suggests a "substantially higher" fine where there is a pattern of multiple violations.[27]

The principal considerations for determining the seriousness of Respondents' conduct are: (1) prior or other similar misconduct; (2) extent of inadequacy in written supervisory procedures and controls; (3) absence of any reasonable explanation for the inadequacy in written procedures; (4) extent of supervisor's periodic review and follow-up; (5) "red flag" warnings that should have alerted firm and/or principal to intensify supervision; (6) extent of any inadequacy in the actual supervision of the employee(s); (7) absence of any reasonable explanation for the supervisory failure; (8) extent of employee misconduct; (9) disciplinary history; (10) demonstrated new corrective measures or controls to prevent recurrence; (11) prompt and voluntary restitution; (12) other mitigating or aggravating factors.

In this case, Respondents' serious violations warrant an upward departure from the Guidelines. La Jolla and Gallison's supervision was so inadequate, it was essentially non-existent; Gallison conducted no personal review or follow-up and he overlooked numerous red flag warnings. Gallison's and La Jolla's non-action led to pervasive employee misconduct and, despite its eventual knowledge of that misconduct, the Firm never offered restitution to its customers and never designed reasonable controls to prevent recurrence. The explanations for the poor procedures and poor supervision are inadequate; Gallison could not have believed in good faith that his patchwork modifications to the supervisory procedures would solve the apparent problems.

The imposition of significant sanctions is also justified by Gallison's and La Jolla's disciplinary histories. See, e.g., In re R.B. Webster Investments, Inc., 51 S.E.C. 1269 (1994) (a respondent's disciplinary history "may [further] demonstrate whether the instant behavior is an isolated occurrence, the sincerity of the applicant's assurance against future violations, and/or the egregiousness of the applicant's current actions." (citing Steadman v. SEC, 603 F.2d 1126,114 (5th Cir. 1979)). See In re Donald T. Sheldon, et al., 51 S.E.C. 59, 78-79 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995); see also In re Adams Securities, Inc., et al., 51 S.E.C. 1092, 1097 (1994); In re G. K. Scott & Co., Inc., et al., 51 S.E.C. 961, 970 (1994), aff'd, No. 94-1161 (D.C. Cir. 1995) (unpublished opinion). That history includes several supervision violations:

> In November 1993, the State of Colorado revoked Gallison's registration with the right to reapply after five years for failing to supervise a Denver, Colorado branch office;
>
> In January 1994, La Jolla responded to allegations by the State of Illinois that La Jolla failed reasonably to supervise at least one salesperson, by consenting to pay a $1,000 fine and agreeing to offer recission of the trades in question;

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[27] See Sanctions Guidelines (1993 ed.) at 44 (Supervision).

In August 1995, La Jolla and Gallison entered into a consent order with the Nevada Securities Division pursuant to which they paid a $25,000 civil penalty, $15,000 in investigation costs, and rescinded investments made by 10 Nevada residents based upon allegations that La Jolla sold unregistered securities and failed properly to supervise a branch office and a registered representative;

In September of 1997, the State of Denver revoked Gallison's registration; barred him from practicing in Colorado; and permitted La Jolla to withdraw its registration after determining that Gallison participated in running La Jolla's Denver office in violation of a 1993 order;

Gallison and La Jolla are currently appealing a February 1998 decision of the National Adjudicatory Council in which they were found to have violated Conduct Rule 3010 by failing to supervise the conduct of representatives in La Jolla's New York Office. The NAC imposed the following sanctions: censure and $100,000 fine each; Gallison was barred from associating with any member in a principal or supervisory capacity and ordered to requalify by examination within 90 days in any other capacity in which he wishes to become associated; and La Jolla was required to retain an independent consultant to audit and monitor La Jolla's compliance program for two years;

In September of 1998, Gallison and La Jolla settled charges brought by the Massachusetts Securities Division that they had fraudulently sold securities and failed properly to supervise their representatives. They agreed to withdraw their registration in that jurisdiction, not to reapply for registration for two years, and to contribute $10,000 to an investor protection and education fund;

Also in September of 1998, the State of Texas issued a disciplinary order against La Jolla for engaging in high-pressure sales tactics, unauthorized transactions, and the use of unregistered agents. La Jolla was reprimanded, suspended for three months, and fined $40,000.

There is little more that this organization can do to Gallison to encourage him to improve his supervision and that of the Firm. Yet, there is much that needs to be done to protect the public from further harm. See In re Paul Edward Van Dusen, 47 S.E.C. 668 (1981) (the purpose of disciplinary sanctions is remedial: to protect the public interest against further risk of harm); In re Kenneth Sonken, 48 S.E.C. 832 (1987). Accordingly, we order that Gallison and La Jolla each be censured, fined $50,000, individually; and barred from engaging in penny stock transactions in any capacity. We also order that Gallison be barred in all principal and supervisory capacities, and suspended in all capacities for 30 days.

Knight's conduct was egregious, and there are no mitigating factors present. Therefore, we impose a fine of $25,000, the highest fine recommended under the applicable Sanctions Guideline. Knight has proven himself incapable of supervising registered personnel, and a threat to the investing public. Accordingly, we order that Knight be barred in all principal and supervisory capacities, and suspended in all capacities for 15 days.

Mehlmann had less authority than Gallison and was, marginally, more proactive in responding to the supervisory problems. He had the responsibility to review the supervisory procedures and the opportunity to recommend modifications, but he failed to do so. Yet, he informed Gallison of the supervisory problems although he was not required to do so. Mehlmann was not qualified to serve as the national compliance officer for such a troubled firm and he received no training from the Firm while in that position. This does not excuse his violations, but does put them in context. He has no prior disciplinary history. Accordingly, we order that Mehlmann be censured, fined $10,000, suspended for 10 days in all principal and supervisory capacities, ordered to requalify by examination as a general securities principal, and assessed $1,000 in DBCC costs.

C. Registration Violations

The applicable Sanctions Guideline suggests a fine of $2,500 to $50,000, plus the fining away of commissions earned by the unregistered individual.[28] It also suggests suspending for 30 days or more, or barring, an individual who willfully or knowingly violates the rule, as well as requiring the individual to requalify by examination.

The principal considerations in fashioning a remedial sanction are: (1) prior or other similar misconduct; (2) whether a registration application had been filed (or an application was pending); (3) length of time functioning as unregistered/improperly registered; (4) knowledge of registration requirements versus "should have known"; (5) frequent or inadvertent use of unregistered persons by the firm; (6) corrective action voluntarily taken upon discovery of problem; (7) extent of supervisory procedures in place at time of violation to detect and prevent registration deficiencies; (8) nature and extent of unregistered person's responsibilities; (9) explanation for failure to register properly; (10) other mitigating or aggravating factors.

The principal considerations weigh heavily against Knight. He had been warned by the Firm regarding previous registration problems, knew that the individuals involved were not registered, used them to facilitate other substantive violations, took no corrective action in response to the problem, and had no reasonable explanation for his misconduct. Knight has a limited disciplinary history.[29] There are no mitigating factors present. Accordingly, we order that Knight be censured, fined $50,000, and barred in all principal and supervisory capacities.

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[28] See Sanctions Guidelines (1993 ed.) at 34 (Registration Violations).

[29] In February of 1997, Knight offered restitution in response to a finding by the Commonwealth of Virginia that he had sold securities while not registered in that jurisdiction.

D. Conclusion

In essence, we affirm the DBCC's imposition of sanctions in all but four respects: (1) all sanctions imposed against Budke and Weaver are eliminated; (2) the fines imposed against La Jolla and Gallison are reduced by $4,000 to reflect the dismissal of two Penny Stock Rules violations by Budke; (3) the fine imposed against Knight for his supervisory violation is reduced from $50,000 to $25,000, which is at the high end of the range recommended by the applicable Sanctions Guideline; and (4) we impose against Knight a 15-day suspension in all capacities. Accordingly, we order that sanctions be imposed as follows:

La Jolla: censure; $297,380 fine, jointly and severally with Gallison; $50,000 fine, individually; bar from participating in penny stock sales or promotion in any capacity; restitution/rescission, jointly and severally with Gallison; and $8,260.75 in DBCC costs, jointly and severally with Gallison.

Gallison: censure; $297,380 fine, jointly and severally with La Jolla; $50,000 fine, individually; bar from associating with any NASD member in any principal or supervisory capacity; bar from participating in penny stock sales or promotion in any capacity; 30-day suspension from associating with any member of the NASD in any capacity; restitution/rescission, jointly and severally with La Jolla; $8,260.75 in DBCC costs, jointly and severally with La Jolla.

Knight: censure; $95,854.55 fine; bar from associating with any NASD member in any principal or supervisory capacity; bar from participating in penny stock sales or promotion in any capacity; 15-day suspension from associating with any member of the NASD in any capacity; and $6,500 in DBCC costs.

Mehlmann: censure; $10,000 fine; 10-day suspension in all principal and supervisory capacities; required to requalify by examination as a general securities principal; and $3,700 in DBCC costs.[30]

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30 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 be summarily 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 be summarily revoked for non-payment.

The suspension imposed will commence on a date to be set by the President of NASD Regulation, Inc. The bars imposed are effective immediately upon the issuance of this decision.

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary