BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee for District No. 3, Complainant, vs. Respondent Firm and Mr. Robert L. Stevens 1880 Arapahoe Street, #2512 Denver, Colorado 80202 and 1405 Adams Street Denver, Colorado 80206, Respondents.	DECISION Complaint No. C3A960009 District No. 3 (DEN) Dated: June 10, 1998

This matter was called for review pursuant to NASD Procedural Rule 9312.[1] We affirm three of the DBCC's findings of violations and reverse one finding of a violation. We find that Robert L. Stevens ("Stevens") violated Article III, Sections 1, 2, and 21 of the NASD Rules of Fair Practice (now known as and hereinafter referred to as "Conduct Rules 2110, 2310 and 3110") by selling unsuitable securities to a trust account and by preparing and submitting inaccurate new account information. We

[1] The National Business Conduct Committee ("NBCC") of NASD Regulation, Inc. called this case for review to determine whether the sanctions imposed by the District Business Conduct Committee for District No. 3 ("DBCC") were appropriate in light of the findings of violations. This matter was decided by the National Adjudicatory Council, which, as approved by the Securities and Exchange Commission, became the successor to the NBCC on January 16, 1998.

find that Respondent Firm ("the Firm") violated Conduct Rule 2110 and Article III, Section 27 of the NASD Rules of Fair Practice (now known as and hereinafter referred to as "Conduct Rule 3010") by failing to supervise Stevens in a manner reasonably designed to achieve compliance with the rules of the NASD pertaining to suitability. We reverse and dismiss the finding that the Firm failed to maintain written supervisory procedures reasonably designed to achieve compliance with all applicable rules and regulations. We affirm the DBCC's imposition of sanctions as to Stevens and order that he be censured, fined $25,565, required to provide restitution of $12,308 plus accrued interest, and suspended for 60 business days. We modify the DBCC's sanctions as to the Firm and order that it be censured and fined $5,000.

Background

Stevens first entered the securities industry in May 1987 when he became associated with a former NASD member firm. Stevens joined the Respondent Firm as a principal in January 1991 and left the Firm in August 1994. The NASD revoked his registration for failure to pay the fine imposed in a previous NASD disciplinary action. He is not currently associated with a member of the NASD.

The firm has been a member of the NASD since November 1983. Its main office is located in Boca Raton, Florida, and the office that is the subject of this action is located in Denver, Colorado.

Facts

In 1991, Customer Z ("Z") agreed to accept a $30,000 settlement of a medical malpractice lawsuit he had filed. Z was 69 years old at the time, and his income that year was approximately $4,700. Z's malpractice attorney apparently recommended that Z establish a trust to hold these funds for tax reasons. In August of 1991, the Z Living Irrevocable Trust ("the Trust") was created, and Z funded the trust with $18,000.

In January of 1992, Z changed the trustee of the Trust, selecting as the new trustee ("the Trustee"), a friend whom he knew through his church. Although Z was the beneficiary of the trust, he was not incompetent, and he participated with the Trustee in making decisions concerning the management of the Trust.

The Z Trust Account. On August 7, 1992, the Trustee opened a new account at the Firm for the Z Trust ("the Trust Account"). Stevens filled out the new account card and served as the account representative. The Trust Account was opened as a cash account with the investment objective of growth. The initial transactions in the account consisted of purchasing two mutual funds from a deposit of $18,000: Growth Fund A for $8,991.71, and Growth Fund B for $8,992.68. These two mutual funds were the only investments that the Trust held between the end of August 1992 and January 1993. The mutual funds are not the subject of the unsuitability allegations against Stevens.

In January of 1993, Stevens recommended that the Trust purchase shares in Company C. The Trust sold all of its shares of Growth Fund A, sold shares of Growth Fund B worth $1,550, and purchased 1,500 shares of Company C at $6 per share for a total cost of $9,308.75, including commissions. Also in January of 1993, the Company C position was transferred by journal entry into a margin account. The January monthly statement showed that at month-end, Company C's market value was $7,517.36, having fallen 16 percent from its value at purchase of $9,000.

In February of 1993, Stevens recommended and the Trust Account purchased 450 shares of Company D. The account purchased Company D on margin at $16 per share, resulting in a month-end margin debit of $7,420.30. Meanwhile, Company C had decreased in value to $6,375. By the end of February, Company D's shares had dropped to $9 1/2, resulting in the Trust Account's Company D shares being worth only $4,275. The combined market value of Company C and Company D was $10,650 and, after deducting the margin debt, the net value of the account had fallen to $3,229.70.

In March of 1993, the Trustee deposited an additional $3,000 into the Trust Account. This deposit was initially credited to the account on March 9, but the check was returned for insufficient funds. On March 17, a $3,000 check was successfully deposited into the account. The $3,000 reduced the margin debt to $4,460. Meanwhile, the decline in the value of Company C continued. At month-end, Company D shares were valued at $10, giving this holding a market value of $4,500. Company C shares were valued at $2 3/8, giving them a market value of $3,562.50. Including the $3,000 deposit, the net closing value of the account at the end of March 1993 was $3,582.62.

In April of 1993, the account sold 350 shares of Company D at $9 3/4 per share to meet a house margin call and sold 300 shares of Company C at $2 1/8 per share, applying the proceeds to reduce further the margin debit. At month-end, the account had a net closing value of $3,174.47. From April until December 1993, the only activity in the account was the accumulation of interest on the margin debt, the balance of which was approximately $550 during this time.

In December of 1993, the account purchased 200 units of Company E, but the Firm sold out the position for nonpayment in January of 1994. At the end of December 1993, Company C had declined to a share price of $.063 and was trading on the Nasdaq National Market System with the "q" qualifier, indicating the company was in bankruptcy. On the January statement, Company C was unpriced. At the end of January 1994, the net market value of the account was $762.62, consisting of the Company D stock at $1,350, less the margin debit of $587.38.

In April of 1994, Company D's share price dropped from $12 to $6 1/2, and the Trust Account sold out the position for $528.50. After applying these proceeds to reduce the margin debit, the account had a net value of negative $70.35. In the course of 20 months, the Trust Account had invested $12,309 based on Stevens' recommendations and had lost the entire amount.

Unsuitable Recommendations

Stevens did not participate in the proceedings before the DBCC. He did not file an answer and did not defend his actions at the hearing. We find that the record fully supports the conclusion of the DBCC that Stevens made unsuitable recommendations to the Trust Account.

Conduct Rule 2310 provides that "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." This rule obligates representatives to make a customer-specific determination of suitability and to tailor their recommendations to the customer's financial profile and investment objectives. In re F.J. Kaufman & Co. of Virginia, 50 S.E.C. 164, 168 (1989).

The record supports the conclusion that Stevens recommended the purchases of Company C, Company D and Company E to the Trustee and Z. We conclude, considering the circumstances of the Trust Account -- that the Trust invested approximately $18,000; that Z, the beneficiary, was 69 years old and seeking to retire; that the trustee had no investment experience; that Z had annual income of only $6,000; and that the investment objective of the trust was growth -- that Stevens recommended unsuitable investments. We find three aspects of unsuitability.

First, the three stocks that Stevens recommended were speculative. Company C's Form 10-K for the year ended December 31, 1991, which was filed in March of 1992, described Company C's core business as being "in the development stage." Over the preceding three years, the company's annual losses had been $3.2 million in 1989, $6.8 million in 1990, and $11.6 million in 1991. At the end of the third quarter of 1992, Company C's stock began trading on the Nasdaq National Market with a "c" modifier because Company C was granted a temporary exception to the capital and surplus requirements for continued inclusion as a Nasdaq National Market security. We find that purchasing Company C stock was a speculative investment.

Company D was a development-stage biotechnology company with its lead product, an immune system drug in Phase III clinical trials. At the end of 1992, Company D had a $14.5 million accumulated deficit and reported a loss for the year of $4.1 million, a loss that was 66 percent higher than the previous year's loss. Over the preceding three years, the stock price had experienced significant volatility. We also find that purchasing Company D stock was a speculative investment.

Company E offered units to the public in an initial public offering ("IPO") underwritten by the Firm and its corporate affiliate, JW Charles Securities, Inc., in December 1993. The Company E units consisted of one share of common stock and one warrant. The front page of the Company E prospectus warned, "These securities are speculative and involve a high degree of risk." The prospectus explained that Company E's accountants had stated that certain conditions raised substantial doubt about Company E's ability to continue as a going concern and that Company E had been unable to make required debt payments as scheduled. We find that the prospectus accurately classified the Company E units as speculative.

Second, Stevens' recommendation that the Trust Account purchase Company D on margin was an unsuitable strategy for the account. Using margin in an account introduces an element of risk that is unsuitable for some customers. See In re Timoleon Nicholaou, 51 S.E.C. 1215, 1217-18 (1994) (holding in a New York Stock Exchange ("NYSE") case, that use of margin in the account of an elderly retiree with very limited means was unsuitable), aff'd 81 F.3d 161 (6th Cir. 1996) (unpublished table decision); In re Stephen Thorlief Rangen, Exchange Act Rel. No. 38486 (April 8, 1997) (holding that for customers with limited investment experience and investment goals of safe, income-producing investments, substantial use of margin was unsuitably risky, in violation of the NYSE's provision requiring that members adhere to just and equitable principles of trade.) Stevens used the margin account to purchase a speculative security and maintained the margin debit for several months. The proportion of the margin debt to the equity in the account was high, with debt of $7,420 versus equity of $10,650 at the time of the Company D purchase. Stevens' sustained use of the margin account to finance the purchase of a speculative security amplified the risks being taken by the Trust. We find that Stevens' recommendation was unsuitable for the Trust.

Third, Stevens' recommendations to purchase Company C and Company D resulted in overconcentration of the Trust Account in speculative securities. A registered representative can make unsuitable recommendations by overconcentrating a customer's investments in one stock. Id. By shifting the Trust from the diversification of the mutual funds into two speculative stocks, Stevens overconcentrated the account in speculative investments.

Based on our review of the Trust Account, we uphold the DBCC's findings that Stevens recommended unsuitable stock purchases to the Trust. We find that Stevens violated Conduct Rules 2110 and 2310 by recommending unsuitable investments.

Inaccurate New Account Card

Cause two of the complaint alleged that Stevens prepared a new account card for the Trust Account that contained inaccurate information about Z and the Trust. Specifically, the complaint alleged that Z's age, income and net worth were inaccurately reported.

When Z and the Trustee opened the Trust Account, Z was 69 years old. Z's personal income tax return for 1992 showed income of approximately $6,000, and the Trust's tax return showed income of approximately $3,300. At its opening, the Trust held approximately $20,000 in investments, a used car, a piano that Z had purchased, and money to pay for ongoing expenses.

The new account card that Stevens filled out showed Z's age as 60, his annual income as $20,000, and his net worth as $40,000. The Trustee testified that he did not tell Stevens that Z was 60 years old, that Z's annual income was $20,000, or that Z's net worth was $40,000. The Trustee also testified that he did not know of Z telling Stevens that his age was 60. Because Stevens did not participate in the DBCC hearing, we do not have his explanation as to why he entered inaccurate information on the new account card. We credit the Trustee's testimony and uphold the DBCC's finding that Stevens prepared and submitted an inaccurate account card. Consequently, we find that Stevens violated Conduct Rules 2110 and 3110, as alleged in cause two.

Failure To Supervise

The Firm's Supervisory Practices. At the time of the DBCC hearing, the Firm had approximately 100 branch offices. Each of these branch offices was an Office of Supervisory Jurisdiction ("OSJ"), and each branch manager was a general securities principal, having passed a Series 24 exam. The Firm's Compliance Director also described all of the Firm's branch offices as independent contractors.

The complaint alleged that the Firm failed reasonably to supervise Stevens' sales of securities to the Trust with respect to suitability. As we discuss below, we uphold this finding because the Firm failed to follow supervisory procedures reasonably designed to detect Stevens' recommendations of unsuitable investments.

At the hearing, the Firm described four procedures it employed to manage its branch offices. First, the Firm reviewed the background of a registered principal who sought to open a Firm branch office and become a Firm licensee. Typically, the Firm's marketing and recruiting staff would gather information regarding a prospective licensee's plans to open a branch office and the licensee's experience selling various investment products. The Firm's Compliance Director and its National Sales Manager would review the prospective licensee's employment and disciplinary history as reflected in Central Registration Depository ("CRD") reports. The Firm would also review the CRD records of the registered persons who were slated to join the new branch office. After reviewing the information gathered, the Compliance Director and the National Sales Manager would decide whether to approve the new branch.

In the case of Stevens' application to open a Denver branch office, the Compliance Director met with Stevens and interviewed him regarding his background, knowledge of the rules and regulations of the industry, and plans for running an office. She reviewed Stevens' CRD record, which showed no disciplinary history. Based on Stevens' prior employment with a former NASD member firm, the

Respondent Firm had its National Sales Manager conduct a background check on Stevens based on his references in Colorado. The Firm also employed a private investigation firm to check Stevens' background. The Firm approved of Stevens' application and, in January 1991, he opened a Firm OSJ in Denver.

The Firm's second management procedure for supervising its branch offices was annual exams. The Compliance Director had a staff of auditors who examined, among other items, whether the branch manager was reviewing trade tickets, monthly statements, advertising, and correspondence, and whether all advertising had been forwarded to the home office. The auditors pulled three to four accounts from each representative in the office and reviewed the accounts back at the Firm's home office. The Firm also held a compliance seminar in the branch office after finishing the exam.

The Compliance Director testified that in February 1992, she audited Stevens' branch office and spoke with him about some of his accounts. She completed the entire compliance checklist for Stevens' branch office and concluded that she had no concern over Stevens' ability to function as branch manager.

Third, the Firm produced an annual seminar at its home office in Boca Raton and asked all of its branch managers and registered representatives to attend. The Compliance Director explained that the seminar usually covered new account procedures, matching customer objectives with investments, and unsuitable transactions. The Firm also conducted a sales convention, which had a compliance component, and conducted regional seminars. The Compliance Director testified that Stevens attended the seminars in Boca Raton annually.

Fourth, the compliance department reviewed exception reports that the Firm generated each month. The Compliance Director testified that the three most important items her department reviewed were accounts with six or more trades in a month, accounts that generated 15 percent or more of a representative's commissions for the month, and accounts that had purchased, sold, and repurchased the same security in a month. In addition, the Compliance Director received a report whenever a representative generated more than $3,000 of commissions in a day. She also received a report when an individual trade generated a commission in excess of $1,000. The Compliance Director explained that the compliance department received information from the trading department on all trades in excess of $25,000, because her department needed to approve these trades. The margin department also generated reports on potentially problematic accounts and discussed those reports with the compliance department.

The Compliance Director testified that none of Stevens' accounts appeared on any exception report. The first indication she received of any problems in Stevens' office was when a customer complained, which resulted in a separate NASD Regulation complaint that was filed in December 1994. She testified that the compliance department attempted to review the monthly statements of every OSJ manager each month. As to Stevens' accounts in particular, however, the Compliance Director had no documentation which showed that her department had reviewed Stevens' customers' monthly statements. The Compliance Director did not testify that her department ever reviewed the Trust Account.

In addition, the Firm had written guidelines that specified how it would monitor the sales activities of its branch managers. These "Guidelines for Branch Manager Trade Review" provided that all branch manager trades in excess of $25,000 were to be reviewed on a daily basis, that a random sample of accounts were to be selected the day after the trade, that accounts would be reviewed monthly on the basis of exception reports, and that 25 percent of branch manager accounts would be reviewed each month. The Compliance Director testified that the compliance department was exceeding its target for monthly reviews and was attempting to review 100 percent of branch manager trades each month.

The Firm's Failure to Supervise Stevens. The DBCC found that the Firm failed to supervise Stevens in a manner reasonably designed to achieve compliance with the rules of the NASD regarding suitability. In its brief responding to our call for review, the Firm conceded that the DBCC's findings of violation were correct. While we accept the Firm's admission that it failed reasonably to supervise Stevens, we will also explain our reasoning in reaching this conclusion.

To comply with the duty to supervise, a firm must not only establish appropriate supervisory procedures, it must actively apply those procedures. See In re Consolidated Inv. Services, Inc., Exchange Act Rel. No. 36687 (Jan. 5, 1996) ("While Applicants may have had a supervisory system in place, it is clear that Applicants took no steps to ascertain whether or not [a registered representative] followed those procedures."). In instances of a registered representative's recommending unsuitable investments to a customer, reasonable supervision requires a firm to take action when a review of a customer's account shows that the customer is making unsuitable investments. See In re Wedbush Sec., Inc., 48 S.E.C. 963, 966, 970 (1988) (finding that a firm had deficient supervision when the firm's President and a Senior Vice President had reviewed a customer account and had taken no action when the account statements showed unsuitable purchases).

A firm can fail in its duty to supervise when it overlooks "red flags" that indicate possible misconduct. See In re Michael H. Hume, Exchange Act Rel. No. 35608 (Apr. 17, 1995); In re Randolph K. Pace, 51 S.E.C. 361, 370 (1993). On the other hand, if a firm is not following procedures designed to detect misconduct, and is therefore committing a supervision violation, the firm may never observe the "red flags" that indicate possible misconduct. See In re Royal Alliance Assocs., Inc., Exchange Act Rel. No. 38174 (Jan. 15, 1997).

Here, we find that because the Firm was not reviewing Stevens' customers' accounts, the Firm was not able to recognize the "red flags" in the Trust Account. The Trust's monthly account statements did contain "red flags" that Stevens was recommending unsuitable transactions. First, the purchases, in January and February 1993, of Company C and Company D should have prompted an inquiry about the account. By reviewing only the monthly statements, the Firm could have determined that the Trust Account was 100 percent invested in speculative stocks.[2] In addition, on the February statement, the Trust Account was carrying a margin balance of more than $7,000 against equities worth $10,650. This volatile combination of speculative stocks and a margin balance that was 69 percent of the value of the stocks in the account was a clear indication that the investments in the account were probably unsuitable.

A second unsuitability "red flag" appeared on the March 1993 monthly statement. This statement showed that despite a deposit of $3,000 to the account, at month-end, the Firm made a house call in the margin account, which resulted in the statement's showing 350 shares of Company D pending settlement. During the month, the value of Company C had declined from $6,375 to $3,562. The liquidation of Company D to meet the margin call and pay down the margin account was a "red flag" that the account's holdings were unsuitable.

In April of 1993, the account statement showed the sale of 300 shares of Company C and that the proceeds of the sale were applied to reduce the balance in the margin account. Although by the end of April the market value of the account was only $3,175, the Firm's inaction over the next year allowed the value of the account to dwindle to zero.

The third red flag that the Firm never observed was the purchase in December 1993 of 200 units of Company E and a sell-out for nonpayment several days later. This sell-out by the Trust of a speculative IPO should have triggered a review of the account.

At the DBCC hearing, the Firm introduced expert testimony regarding its branch office supervisory procedures. John Smith, a securities industry member with more than 20 years of experience, testified that he had reviewed the Firm's branch audit procedures and found that they exceeded industry standards. We conclude that Smith's testimony does not exonerate the Firm from its failure to supervise Stevens. Although the Firm had procedures for monitoring Stevens' sales activities, the record shows that these procedures were not being used. Because no one at the Firm reviewed the Trust Account for over a year, we find that the Firm inadequately supervised Stevens.

We conclude that the Trust Account's statements plainly showed that the assets of the Trust were invested in speculative stocks, one of which was purchased and held using margin. Either because

[2] Although the Trust still held shares of Growth Fund B, the mutual funds did not appear on the Trust Account's monthly statements after August of 1992. Therefore, the February statement showed that the Trust Account held only Company C and Company D.

the Firm's compliance department did not review this account during 1993, or because the review was meaningless, the Firm failed to respond to evidence of unsuitable investments. We find that the Firm failed reasonably to supervise Stevens because the Firm did not follow procedures for reviewing Stevens' accounts that were reasonably designed to detect unsuitable recommendations. We uphold the DBCC's findings that the Firm violated Conduct Rules 2110 and 3010, as alleged in cause three.

Inadequate Written Supervisory Procedures

The Firm's Responses To Inquiries. Cause four of the complaint alleged that the Firm failed to establish and maintain written supervisory procedures for supervisory review of transactions effected by OSJ managers who were registered principals, such as Stevens. During the investigation of this case, the Firm took the position that the NASD's rules did not require it to supervise an OSJ branch manager who was a registered principal. In response to a request from the District No. 3 staff to describe the supervision of Stevens, the National Sales Manager stated: "Since each office of [the Firm] is an OSJ with each branch manager as a Series 24, those branch managers have final approval of the opening of all accounts, margin accounts and the determination of the suitability of a particular trade." The Firm's Compliance Director testified that during District No. 3's investigation of this case she had stated that Stevens was supervising himself. The Firm's Memorandum of Supervisory Procedures, which was in effect from October 1991 through October 1993, did not specify that branch managers' accounts would be reviewed by anyone other than the branch managers themselves.

The Firm did, however, have written "Guidelines for Branch Manager Trade Review," which it introduced as an exhibit at the DBCC hearing. In responding to a question about why she had not provided the "Guidelines for Branch Manager Trade Review" to the staff before the DBCC hearing, the Compliance Director testified that the guidelines were not part of the required written supervisory procedures of the Firm, but rather were "something extra," which the Firm used for its oversight of branch managers.[3]

Analysis of the Firm's Written Supervisory Procedures. We reject the Firm's attempt to characterize its "Guidelines for Branch Manager Trade Review" as anything other than written supervisory procedures. Based on these "Guidelines for Branch Manager Trade Review" and the Firm's other written supervisory procedures, we find that the Firm had adequate written supervisory procedures addressing supervision of branch manager trading. As discussed above, however, we find

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[3] The Compliance Director also stated that the compliance department did not want to include these guidelines in the edition of the Firm's supervisory manual that is available in each office. We do not require that all of a firm's procedures to supervise branch managers be included in widely available manuals. We require only that firms provide to NASD Regulation investigators all written supervisory procedures regarding branch managers when the investigators ask for such procedures.

that the Firm did not follow its guidelines in this case.[4] Here, we find that the failure to supervise Stevens resulted from the Firm's deficient practices, not from inadequate written procedures. Because we have found that the Firm's supervision of Stevens was inadequate under cause three, we do not find a violation as alleged in cause four based on the same misconduct.

Nevertheless, the Firm's responses to the District No. 3 investigative staffs' inquiries do demonstrate a troubling misunderstanding of a firm's obligation to supervise all registered persons, both registered representatives and registered principals. Conduct 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." In the NASD's June 1997 Regulatory & Compliance Alert, an article regarding supervision of off-site Series 8- or Series 24-qualified salespersons stated that: "There is no such thing as an OSJ that can supervise itself." The article continues, "Series 8 or 24 qualified persons are no more capable to supervise themselves than a Series 7 qualified representative." The SEC ruled last year that a broker/dealer with numerous, small offices of supervisory jurisdiction had inadequate procedures for detecting the improper use of a signature guarantee stamp when, in effect, the branch manager himself identified when he used the signature guarantee. In re Royal Alliance Assocs., Inc., Exchange Act Rel. No. 38174 (Jan. 15, 1997).

Based on our finding that the Firm's "Guidelines for Branch Manager Trade Review" are written supervisory procedures, we reverse the DBCC's finding of a violation and dismiss the fourth cause.

Sanctions

As to Stevens, the DBCC imposed sanctions of a censure, a $25,565 fine, an order to provide to District No. 3 staff proof that he had made restitution to Z in the principal amount of $12,308 plus accrued interest, and a 60-day suspension.

We affirm these sanctions.[5] Stevens opened the Trust Account using inaccurate information. He then disregarded the interests of his customer when he recommended a highly risky course of action

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[4] We do not condone a firm's giving incomplete responses to requests made by NASD Regulation investigators, after which the same firm designates as exhibits for a disciplinary hearing more complete responses, including new documents that were not part of the firm's earlier response.

[5] We apportion the sanctions as follows: for the suitability violation, we impose a censure, a fine of $25,565 (including $565 of commissions), restitution, and 30 days of the suspension. For the inaccurate customer record, we impose 30 days of the suspension. The recommended sanctions for Stevens are consistent with the applicable NASD Sanction Guidelines ("Guidelines"). See Guidelines (1993 ed.) at 33, 43 (Recordkeeping Violations and Suitability).

for this trust account. Stevens' unsuitable recommendations to sell mutual fund shares and purchase speculative equities, in some cases on margin, led to the Trust's being rendered nearly worthless. Although the account was small from the Firm's perspective, the loss was substantial for Z. Z had no other source of savings for his retirement, and he had hoped that the Trust would supplement his Social Security payments.

As to the Firm, the DBCC declared that its decision should serve as a Letter of Caution and imposed costs of the DBCC hearing. We increase these sanctions by censuring the Firm and fining it $5,000. We affirm the imposition of the costs of the DBCC hearing.

The Firm contends that its sanctions should remain light because, it argues, there is no clear support for the proposition that branch managers may not be delegated responsibility to supervise their own accounts. The Firm is incorrect. As we have already discussed, Conduct Rule 3010 requires that each registered person have a supervisor. It is well established that a system of supervisory procedures which relies solely on the branch manager is insufficient. In re Dickinson & Co., Exchange Act Rel. No. 36338 (Oct. 5, 1995); In re Shearson Lehman Brothers, Inc., 49 S.E.C. 619, 627 (1986). In addition, a firm does not meet its duty to supervise merely by designating each branch as an OSJ and assigning it a Series 24 principal. Cf. In re Prudential-Bache Secs., Inc., 48 S.E.C. 372, 400 (1986). The SEC requires firms 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 Stuart K. Patrick, 51 S.E.C. 419, 422 (1993), aff'd, 19 F.3d 66 (2d Cir.), cert. denied, 513 U.S. 807 (1994). Consequently, the NASD and the SEC have unambiguously set forth the requirements that branch managers in OSJs cannot supervise themselves.

The Firm also argues that the securities industry was not on notice at the time of Stevens' misconduct in 1993 that branch managers could not supervise their own accounts. Based on our discussion of case law in the preceding paragraph, we find that this argument has no merit. Moreover, as the SEC explained when reviewing conduct that occurred in 1989 to 1993, a firm that chooses to establish offices with one or two registered representatives has arrangements that "necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion . . . to meet the same high standards of supervision as at more traditionally organized firms." In re Royal

Alliance Assocs., Inc., Exchange Act Rel. No. 38174 (Jan. 15, 1997).[6] Our review of the existing legal authorities refutes the contention that we are requiring the Firm to observe a new and higher standard. Consequently, we reject the Firm's argument that a downward departure from the Guidelines would be justified because the Firm was not on notice of its supervisory responsibilities.

In considering the sanctions we will impose on the Firm, we have weighed the "Principal Considerations in Determining Sanctions" that are listed in the Sanction Guideline for supervision violations. The Firm has a disciplinary history that includes other supervisory violations. In May of 1995, the Firm entered into a settlement with the SEC over allegations that the Firm had failed reasonably to supervise a registered representative when she, without approval from the Firm, induced or attempted to induce the purchase of common stock. The Firm agreed to sanctions of a censure, a $30,000 civil penalty, and employment of an independent consultant who would review its supervisory procedures. In December of 1994, the Firm entered into a consent order with the state of Maryland for failure reasonably to supervise an agent who had engaged in unauthorized, unsuitable, and excessive trades. The Firm agreed to pay a $5,000 fine and abide by compliance measures. We do not find that these settlements involved situations similar to the case before us or otherwise indicate circumstances that support aggravation of sanctions in this matter.

Here, the record reflects that the Firm had a lapse in one aspect of its duty to supervise, but this case did not involve a complete breakdown of its supervisory system. The Firm conducted a thorough investigation of Stevens before hiring him as a branch manager. We do not fault the Firm for a lack of diligence when hiring Stevens. The Firm's procedures for review of branch manager accounts, if properly followed, should have detected the problems in the Trust Account. The "red flags" that indicated potential problems with the Trust Account were not ignored; rather, they apparently were never seen by the Firm. We do, however, consider the Firm's supervisory deficiency serious because the Firm did not explain why the compliance department never reviewed the Trust Account. Finally, we analyze the character of the underlying misconduct, which we find was serious. Taking into consideration all of these circumstances, we conclude that the appropriate level of sanctions for the Firm is a censure and a $5,000 fine.[7]

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[6] See In re Pru-Bache Secs., Inc., 48 S.E.C. 372, 400 (1986) (holding that a firm's failure to have regional monitoring of branch managers was inadequate supervision and noting that a firm cannot dissipate its managerial responsibilities by geographic fragmentation). Likewise, the NASD has imposed sanctions on firms when they inadequately supervised branch managers. See In re Investment Management & Research, Inc., No. C3B940028, National Business Conduct Committee, at 53, 1997 NASD Discip. LEXIS 43, at *113 (NBCC July 25, 1997) (observing that the NASD and SEC have long noted the problems that can arise in branch offices and the need for appropriate supervision of one-person offices).

[7] The recommended sanctions for the Firm are consistent with the applicable Guidelines. See

Accordingly, we order that Stevens be censured, fined $25,565, ordered to provide to District No. 3 staff proof that he made restitution to Z in the principal amount of $12,308 plus accrued interest from April 30, 1994 to the date of payment at a rate of nine percent per annum or the rate set forth at 26 U.S.C. ' 6221(a)(2), whichever is less, and suspended from association with any member of the NASD in any capacity for 60 business days. We order that the Firm be censured and fined $5,000. Pursuant to Rule 9360, the Chief Hearing Officer shall set the date on which the suspension shall begin.[8]

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

Guidelines (1993 ed.) at 44 (Supervision).

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

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