BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 5 Complainant, v. Respondent 1, Respondent.	DECISION Complaint No. C05950018 District No. 5 Dated: August 28, 1997

This matter was appealed by Respondent 1 pursuant to NASD Procedural Rule 9310. For the reasons discussed below, we hold that Respondent 1 violated Article III, Sections 1 and 28 of the Association's Rules of Fair Practice (now and hereinafter referred to as Conduct Rules 2110 and 3050), and we order that he be censured; fined $3,544.27; and assessed hearing costs of $541.50.

Background. Respondent 1 entered the securities industry in 1964 as a general securities representative. From May 1991 through March 30, 1992, he was registered as a general securities representative and associated with Firm A. From March 26, 1992 through July 5, 1995, he was registered as a general securities representative and associated with Firm B. Respondent 1 is currently not registered with the Association, nor is he associated with a member firm.

Facts

During the course of a routine examination of Firm A conducted in January 1994, the staff of NASD Regulation, Inc. District No. 5 reviewed certain underwritings in which Firm A had participated. As a result of this examination, District staff discovered that Respondent 1, while registered with Firm B, had purchased shares of Company A, a public offering stock that immediately traded at a premium in the secondary market ("hot issue").

A staff compliance specialist ("Examiner") testified that, during his review of Respondent 1's account activity at Firm A, he discovered that in six instances Respondent 1 had purchased shares of hot issue stocks. The Examiner testified that there was a "total immediate profit" of approximately $2,100 on these six transactions. The total immediate profit was computed based on the spread between the immediate aftermarket price of the initial public offering and the public offering price, multiplied by the number of shares. The actual profit realized by Respondent 1 on the six subject transactions was $1,226.76. The six subject purchases occurred between February 3 and June 30, 1993, during which time Respondent 1 was registered with Firm B. Respondent 1 retired from Firm A on March 30, 1992, and his affiliation date with Firm B was March 26, 1992. The Central Registration Depository ("CRD") records reflected that Respondent 1's termination from Firm B took place in July 1995. No one at Firm B was made aware of the six subject transactions.

In a written response to District staff's inquiry, Respondent 1 explained that he became affiliated with Firm B after he retired from Firm A. At that time, he had a contractual agreement not to compete with Firm A. According to Respondent 1's response, "[a]dvice from brokerage friends suggested that [he] place [his] license with [Firm B] in order to prevent its expiration [but he] did not at any time consider [himself] under the employment or obligation of [Firm B]." Respondent 1 explained at the DBCC hearing that because of a lawsuit filed against him by Firm A based upon the non-compete agreement in his employment contract, he told Firm B in April 1992 that he was not going to work there. He testified that he never transferred an account to, or put any orders in, at Firm B. Shortly after April 1992, Respondent 1 left North Carolina and pursued other business interests. According to Respondent 1, Firm A must have known that he had moved his license to Firm B because Firm A initiated the lawsuit. Respondent 1 was aware of the policy at firms where he had been employed that a broker was restricted from purchasing hot issues. He did not think that there was a problem with the six transactions at issue because no one said anything to him.

Discussion

Cause One. The first cause of the complaint alleged, and the DBCC found, that from February 3, 1993 through June 30, 1993, Respondent 1, an employee of member firm, Firm B, purchased stock in a total of six initial public offerings through member firm Firm A, for an account in which he had a beneficial interest. These purchases each involved hot issues. This conduct was alleged to have constituted separate and distinct violations of the Board of Governors' Interpretation with respect to Free-Riding and Withholding (now IM-2110-1) (the "Free-Riding and Withholding Interpretation") of Conduct Rule 2110. This Interpretation provides that it is a violation of Conduct Rule 2110 to fail to make a bona fide public distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins, regardless of whether such securities are acquired by the member as an underwriter, a selling group

member or from a member participating in the distribution as an underwriter or selling group member, or otherwise. The Interpretation specifically provides that it is a violation of Conduct Rule 2110 for a member or person associated with a member to continue to hold any of the securities so acquired in any of the member's accounts.

The purpose of the Free-Riding and Withholding Interpretation is to "ensure that NASD members and their associated persons make a bona fide distribution to the public of securities that are part of the public offering." In re First Philadelphia Corp., et al., 50 S.E.C. 360, 361 (1990). The Interpretation is designed to prevent restrictions on the supply of offerings that trade at an immediate aftermarket premium. Id.

In a free-riding case, it is "immaterial, except in connection with fixing the nature of the sanctions to be imposed in the public interest, whether [the respondent] was aware [he] was violating the NASD rules." In re Rothschild Securities Corp., et al., 45 S.E.C. 444, 446 (1974); see also In re First Philadelphia Corp., et al., 50 S.E.C. 360, 361-62 (1990) (rejecting arguments that would "read an element of scienter into a rule which is prophylactic in nature and does not require scienter to support a finding of violation" and noting that violations of the Interpretation "need not be intentional"). We find that even if at the time of the transactions at issue Respondent 1 did not think he was employed by Firm B, and thus thought that he was free to purchase a hot issue, he was actually still registered with the Association[1] and thus violated the Free-Riding and Withholding Interpretation. It is not necessary to find that Respondent 1 acted intentionally because even an inadvertent violation is sufficient to find that Respondent 1 violated Conduct Rule 2110.

The Securities and Exchange Commission ("the Commission") has held that proof of a violation requires a showing that the initial aftermarket activity was at a price higher than the offering price. In re Charles Martin Powell, 51 S.E.C. 601 (1993) (dismissing an NASD disciplinary action involving an alleged violation of the Free-Riding and Withholding Interpretation because the Commission was unable to determine from the record that the transactions were effected at a premium over the offering price and occurred at the opening of the market). After reviewing the record in this case, the NBCC issued an Order of Remand dated October 28, 1996. In that Order, the NBCC noted that other than a schedule prepared by staff, there was no evidence in the record of the initial public offering price or of the secondary market trading showing that the stocks at issue traded at a premium in the immediate aftermarket. The NBCC thus ordered the record to be supplemented on remand with evidence that the securities at issue traded at an immediate aftermarket premium. The NBCC also noted that other than this schedule prepared by staff,

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[1] According to the CRD records, Respondent 1 was registered as a general securities representative with Firm B from March 26, 1992 through July 5, 1995. The hot issue purchases took place from February 3, 1993 through June 30, 1993.

there was no evidence in the record that the "hot issue" securities were placed into an account in which Respondent 1 had a beneficial interest, nor was there evidence of the prices at which Respondent 1 bought and sold the securities. The NBCC also directed the DBCC to reconsider the sanctions in light of the NASD Sanction Guidelines ("Guidelines").

Pursuant to the Order of Remand, regional counsel supplemented the record with copies of account statements for Respondent 1, dated January through July 1993, which demonstrated that the six securities purchases were made in Respondent 1's account at Firm A. The regional counsel also supplemented the record with a revised schedule prepared by staff and with trade reports for five of the six subject securities showing inter-dealer trades during the first 15 minutes of trading on the first day of market trading for these initial public offerings. Respondent 1 stipulated to the entry of these exhibits into the record. On remand, the DBCC affirmed the sanctions it had previously imposed even though it recognized that the fine amount was slightly lower than that recommended by the applicable Guidelines.

According to the trade reports introduced into the record by staff, the first trade of the day for Company A stock on February 3, 1993 was at a price of $12.25. Respondent 1 purchased Company A stock at the initial public offering price of $10 and sold it in the aftermarket at $11.75. We find that Company A stock was a hot issue purchased by Respondent 1 while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Company B stock on May 20, 1993 was at a price of $19.25. Respondent 1 purchased this stock at the initial public offering price of $17 and sold it in the aftermarket at $19.25. We find that Company B stock was a hot issue purchased by Respondent 1 while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Company C stock on June 8, 1993 was at a price of $11. Respondent 1 purchased this stock at the initial public offering price of $10 and sold it in the aftermarket at $10.25. We find that Company C stock was a hot issue purchased by Respondent 1 while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Company D stock on June 30, 1993 was at a price of $22. Respondent 1 purchased this stock at the initial public offering price of $16 and sold it in the aftermarket at $22. We find that Company D stock was a hot issue purchased by Respondent 1 while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Company E stock on March 12, 1993 was at a price of $15.50.[2] Respondent 1 purchased this stock at the initial public offering price of $14 and sold it in the aftermarket at $14.75. We find that Company E stock was a hot issue purchased by Respondent 1 while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

The record does not contain a trade report for Company F stock. Pursuant to the Commission's finding in Powell, supra, we find that there is insufficient evidence in the record to support a finding that this stock traded at a premium over the initial public offering price at the opening of the market and therefore was a hot issue. Accordingly, we dismiss the allegations of the complaint relating to for Company F stock.

Cause Two. The second cause of the complaint alleged, and the DBCC found, that Respondent 1 failed and neglected to notify his employer member firm Firm B in writing that he had established and maintained a separate securities account with Firm A. In addition, Respondent 1 failed and neglected to inform Firm A in writing of his association with Firm B. This conduct was alleged to have constituted separate and distinct violations of Conduct Rules 2110 and 3050. Conduct Rule 3050(c) provides that an associated person:

> prior to opening an account or placing an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or her association with the other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both members in writing promptly after becoming so associated.

Consequently, pursuant to Rule 3050, Respondent 1 was required to notify Firm A in writing of his association with Firm B and was required to notify Firm B of the account he maintained at Firm A. Respondent 1 did not deny that he had never provided Firm B with written notice of his account at Firm A. Respondent 1 testified that he provided Firm B with verbal notice that he had an account at Firm A. The record is clear that no written notice was given by Respondent 1 to either Firm A or Firm B and we therefore affirm the DBCC's findings that Respondent 1 violated Conduct Rules 2110 and 3050 as alleged in the second cause of the complaint.

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[2] The trade report shows the first trade of the day for Company E stock on March 12, 1993 was at 15 128B. This means 15 128/256 or 15-1/2.

Sanctions. The DBCC imposed sanctions of a censure and a fine of $4,126.76. This amount represents the actual profits earned by Respondent 1 on the alleged six hot issue transactions plus a $2,500 fine. Since we are dismissing the findings with respect to for Company F stock, we reduce the fine amount by $582.49, the actual profit earned by Respondent 1 with respect to this stock. We agree with the DBCC that sufficient mitigation exists to depart from the Sanction Guidelines,[3] which recommend a fine that includes transaction profit. Transaction profit is defined as the greater of the immediate aftermarket unrealized profit (the price determined to be the immediate aftermarket price times the number of shares minus the public offering price) or the actual profit realized. In Respondent 1's case, the transaction profit would be greater than the actual profit realized. Respondent 1, however, has had no prior disciplinary history for the past 30 years, the violation was inadvertent, and the amounts were minimal. We find that these are sufficient mitigating circumstances to base the fine amount on Respondent 1's actual profits rather than the transaction profit.

Accordingly, Respondent 1 is censured; fined $3,544.27; and assessed hearing costs of $541.50.[4]

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

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[3] See, Guidelines (1993 ed.) at 24 (Free-Riding and Withholding).

[4] 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 summarily be revoked for non-payment.