BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee for District No. 3 Complainant, vs. Respondent 1, Respondent.	DECISION Complaint No. C3A960014 District No. 3 Dated: November 18, 1997

This matter was appealed by Respondent 1 pursuant to Procedural Rule 9310. For the reasons discussed below, we find that Respondent 1 engaged in private securities transactions in violation of Article III, Section 40 of the NASD Rules of Fair Practice (now known and hereinafter referred to as "Conduct Rule 3040"), and Article III, Section 1 of the NASD Rules of Fair Practice (now known and hereinafter referred to as "Conduct Rule 2110"). We affirm the censure and $5,000 fine.

Background. Respondent 1 entered the securities business in September 1976 as a representative of member firm, Firm A. During the period relevant to the complaint, Respondent 1 was associated with member firm, Firm B, where he was registered as a general securities representative. Respondent 1 is not currently associated with an NASD member firm.

Factual Background. The complaint alleged that, during the period from approximately October 1, 1993 through February 14, 1994, Respondent 1 participated in private securities transactions without providing prior written notification to Firm B as required by Conduct Rule 3040, in violation of Conduct Rules 2110 and 3040.

Before Respondent 1 commenced his association with Firm B in August 1993, the Firm B Branch Manager requested pre-authorization for Respondent 1's affiliation with Company A[1] in a July 27, 1993,

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[1] Company A was formed to "create and operate an interactive audio-visual communications network for the global healthcare market." Respondent 1 became involved with Company A in 1991 through an entity named Company B. It was the purpose of Company B to identify business opportunities in telemedicine and distance learning for continuing medical education and to build a business plan for the

memorandum to the Firm's main office. The Branch Manager stated in the memorandum that Respondent 1 served as a director of the company and also received compensation for "marketing advice." The Branch Manager also stated in the memorandum that Company A expected "to have significant capital needs over the next few years" and that there had been "discussions with [Firm B's] Capital Markets Group about being of assistance." Several days later, an attorney in the Firm's legal department, faxed a memorandum to the Branch Manager in which he stated that Respondent 1's Company A affiliation appeared to be "approvable" and that Respondent 1 should disclose the affiliation on his Employee Reporting Statement ("Employee Statement") so that final approval could be given. Consistent with that instruction, Respondent 1's Employee Reporting Statement, dated August 13, 1993, disclosed the affiliation and reported that he was paid $3,000 to $5,000 per month for consulting services.[2] The Employee Reporting Statement did not request information about the nature of the affiliation and Respondent 1 provided none.

At the time of Company A's incorporation in 1992, Respondent 1 was a registered representative of Firm C. In December 1992, Respondent 1 advised Firm C in writing that he worked in the evenings and on weekends conducting the company's business plan and developing a matrix of possible investment banking scenarios; that he had received no cash compensation to date and would not for the foreseeable future; and that his compensation had been in the form of the stock that he and the co-founders jointly owned.

In January 1993, Respondent 1 provided a written notice to Firm C, stating that he wanted to "update" the firm on his "increased business involvement" with Company A. In this notice, he stated that, among other things, he would be acting as a liaison between the company and the "Investment Banking Area" and advised the Firm that the company would be paying him a consulting fee or other compensation as a result of his increased commitment of time on Company A matters. Firm C responded in February 1993 with a memorandum from the Compliance Department advising Respondent 1 that "[t]his memo will serve as the firm's approval for you to participate in an outside business activity involving the offering and sale of shares of [Company A] in a private placement with a minimum investment of 30,000 shares."

Firm C conditioned its approval on the execution by each investor of a "hold harmless" letter acknowledging that the investor did not rely on Firm C or on Respondent 1 as an agent of the firm in making the investment; that the Firm C did not perform any due diligence with respect to the offering; and that the investor was able to accept the risk of the investment. Firm C memo indicated that the firm would

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successor entity, Company A, which was incorporated in 1992. Respondent 1 was one of the founding directors of Company A and a major shareholder and was involved with "strategic as well as tactical planning" for the company.

[2] In May 1993, Respondent 1 and Company A entered into a consulting agreement pursuant to which Respondent 1 was paid $3,000 to $5,000 per month for performing certain services as described in the agreement, including "[working] with the company to research, interview and contract with domestic and international investment banking firms for the purpose of raising capital for the company."

prepare the "hold harmless" letter for Firm C investors and that its approval was for the referenced private placement only.

During late 1992 and early 1993, Respondent 1 and the Branch Manager were having discussions about the possibility of Respondent 1 joining the Firm B branch office. The Branch Manager testified that those discussions intensified in the Spring of 1993, a time when Company A was engaged in the offering referenced in the Firm C Compliance Department memorandum described above. The Branch Manager also testified that in April 1993, he attended a presentation concerning the offering at a hotel at which Respondent 1 was one of the presenters. The Branch Manager further testified that while he clearly knew from his attendance at the April 1993 seminar that Respondent 1 had participated in raising capital for UMN, he did not expect that effort to continue because he understood that the Spring offering had met the company's near-term needs for capital and because he expected any future capital-raising activities to be presented to Firm B first.

On September 30, 1993, Company A commenced a private placement of 1,600,000 shares of common stock at $3 per share ("Offering"). According to the private placement memorandum, shares would be offered by the company's officers and directors and potentially through registered broker/dealers. The offering was made to accredited investors and was to terminate on December 31, 1993. The private placement memorandum disclosed that Respondent 1 was a director of Company A and the beneficial owner of 12.9% of the company's outstanding shares and referenced his association with Firm B. Respondent 1 participated in several presentations to potential investors in the private placement during the Offering.

The record also contains a memorandum dated October 4, 1993, from the Branch Manager to Respondent 1 in which the Branch Manager advised Respondent 1 that he was not permitted to participate in the sales process of any private placement that the Firm had not approved. The memorandum further advised Respondent 1 that, according to Firm B's legal department, the "hold harmless" letter used by Firm C only partially insulated Firm C from liability to investors. The memorandum also stated that it was more likely that Firm B would approve participation in a public offering than that the Firm would approve participation in a private placement. The Branch Manager testified that he prepared the memorandum after a discussion he had with Respondent 1 in which Respondent 1 had requested clarification as to what he could and could not do. The Branch Manager also testified that he had provided the legal department with a copy of the Firm C "hold harmless" letter and that he had delivered the October 4 memorandum to Respondent 1 after composing it. Respondent 1 testified that he did not receive the memorandum.

In the Fall of 1993, Firm B received an inquiry from a State Securities Commission asking whether transactions in Company A's offering were reported on the books and records of Firm B and whether Firm B was aware of Respondent 1's participation in the Offering. The Firm inquired into Respondent 1's participation in the Offering during November 1993 in connection with its response to the inquiry. The Firm's regional legal counsel, testified that he first learned that Respondent 1 had participated in sales activities with respect to Company A when Respondent 1 advised him of that fact on November 19, 1993 during a conference call. The Branch Manager and the Firm's regional legal counsel testified that it was at

that point that the legal department became directly involved. The Firm's regional legal counsel testified that he received a copy of Respondent 1's consulting agreement with Company A for the first time in December 1993.

The Firm's regional legal counsel testified that either he or the Branch Manager clearly communicated that Respondent 1 should cease all capital-raising for Company A. The Branch Manager testified that during a telephone conversation in November 1993, attorneys from Firm B's legal department instructed Respondent 1 not to attend a sales presentation he had planned to attend the following day and that Respondent 1 complied. In a letter to Respondent 1 dated February 14, 1994, Firm B formally told Respondent 1 to cease all capital-raising for Company A. The Firm's Regional Legal Counsel also testified that Respondent 1 had never provided to Firm B a written notice that complied with the requirements of Conduct Rule 3040.

The Branch Manager testified that he did not learn of the private placement until the Firm received the request from the State Securities Commission and did not know of Respondent 1's involvement until the Firm's inquiry in response to that request in November. He also stated that he had not seen a completed private placement memorandum until preparing for the hearing, although he had reviewed the pages disclosing Respondent 1's affiliation with Company A during the process of responding to the State Securities Commission request. The Branch Manager testified that he had sought approval of the affiliation from the Firm based on his understanding that Respondent 1's involvement with Company A after associating with Firm B was limited to serving on the Board of Directors and providing consulting services in the marketing area.

Respondent 1's former sales assistant, testified that the Branch Manager must have been aware of Respondent 1's involvement with Company A because of his attendance at the April 1993 sales presentation and because the Branch Manager understood that if Respondent 1 came to work for Firm B, the sales assistant would work solely for Respondent 1 for at least one year because of the time that Respondent 1 would be devoting to Company A. She also stated that she provided the Branch Manager with the Firm C Company A due diligence file and that she did not recall Respondent 1 receiving the October 4, 1993 memorandum concerning the limitations on his ability to participate in the Company A private placement. The sales assistant testified that it was well-known in the office that Respondent 1 was assisting Company A in raising capital and that she used the office facilities to send out offering documents for Respondent 1. An employee who worked down the hall from Respondent 1, also testified that it was common knowledge in the office that Respondent 1 was raising money for Company A. The sales assistant testified that she had discussed Respondent 1's Company A activities with the Branch Manager and that he had never advised her that Respondent 1 was violating any Firm B policies.

The former chief financial officer of Company A, testified that Respondent 1 was not specifically compensated for his participation in the private placement. He also testified that Respondent 1's compensation had been paid pursuant to the consulting agreement, which specified his duties. With respect to those duties, he indicated that Respondent 1 had undertaken the enumerated responsibilities, including

those pertaining to raising capital. He also testified that Respondent 1 performed duties that were not specifically listed in the consulting agreement.

The former chief executive officer of Company A, testified that Respondent 1's role in the sales presentations consisted of bringing in potential investors that Respondent 1 had suggested might be interested in purchasing Company A securities and responding to inquiries from potential investors in the areas in which he had responsibility at Company A. He further stated that he had sent faxes and engaged in telephone conversations with Respondent 1 about Company A's financing efforts while Respondent 1 was at the Firm B office; that Respondent 1 had made no effort to hide his involvement; and that no one from Firm B had ever communicated to him in September or October 1993 that Respondent 1's work for Company A violated any policies or rules to which Respondent 1 was subject.

Discussion. Conduct Rule 3040(a) states that no associated person shall participate in any manner in a "private securities transaction" except in accordance with the requirements of the rule. It is undisputed that the sale of Company A units in connection with the Offering in 1993 constituted private securities transactions as contemplated by the rule. Conduct Rule 3040(b) requires an associated person to provide written notice to the member with which he is associated, before participating in any private securities transaction, describing in detail the proposed transaction and the person's proposed role in the transaction and whether the person has received or may receive selling compensation in connection with the transaction. In the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

On the basis of the evidence in the record, we find that Respondent 1 participated in private securities transactions without providing the required prior written notice to Firm B, in violation of Conduct Rules 3040 and 2110.[3] It is undisputed that Respondent 1 was very involved in fund raising activities for Company A. Specifically, Respondent 1 brought prospective investors to offering meetings and participated in sales presentations at those meetings. Based on this evidence, we conclude that such activity constituted participation in a private securities transaction.

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[3] We have accepted into the record on appeal two exhibits that Respondent 1 requested be adduced as additional evidence. As to the first exhibit (a list of individuals who worked at the company where the Branch Manager's son was employed ("Firm D") and to whom Company A private placement memoranda had been sent), the Subcommittee determined that the document previously had been included in the record as "Exhibit K." With respect to the second exhibit, which is a group of documents showing that a Firm B employee bought a Company A promissory note through his IRA account at the Firm, the Subcommittee determined to admit these documents into the record to assure that the record was complete. We ratify and adopt the Subcommittee's rulings. We have not accepted into the record Respondent 1 1994 Employee Reporting Statement that Respondent 1 requested be adduced as additional evidence. Our decision not to accept into evidence this additional document is based on the fact that the respondent failed to satisfy the requirements in Procedural Rule 9312 that notice of the intention to introduce such evidence be made no later than 10 business days prior to the date of the hearing and be material to the proceeding.

We reject Respondent 1's argument that the Firm C due diligence file and the private placement memorandum for the Offering satisfied the prior written notice requirement of Conduct Rule 3040. The Securities and Exchange Commission ("SEC") has held that the requirement in Conduct Rule 3040 to describe the proposed transaction "in detail" requires at the very minimum that the identity of the investor and the amount involved be provided. In re William Louis Morgan, 51 S.E.C. 622, 627, n.19 (1993). Although it is unclear from the record whether the Branch Manager ever received the Firm C due diligence file that contained the "hold harmless" letter or the private placement memorandum for the Offering from Respondent 1 or his assistant, we conclude that in any event such documents do not satisfy the requirement in the rule that an associated person describe "in detail" the proposed transaction and his or her role in it.[4]

We further reject Respondent 1's argument that the onus was on Firm B to advise him that any notice that he did provide to the firm was inadequate.[5] As a registered representative, Respondent 1 was

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[4] Respondent 1's former sales assistant testified that she had given the Branch Manager a copy of the Firm C due diligence file. Respondent 1 argued at both the DBCC hearing and the appeal hearing that the Branch Manager had been given copies of both the Firm C due diligence file and the private placement memorandum for the Offering. The Branch Manager testified, however, that he had never received the documents from either Respondent 1's former sales assistant or Respondent 1. The Branch Manager testified that he had not seen the documents at issue until they had been provided to him by the Firm sometime in late October or early November 1993 in connection with the State Securities Commission inquiry. Notwithstanding that testimony, we note that the Branch Manager also testified that he had provided Firm B's legal department with a copy of the "hold harmless" letter prior to preparing the October 4, 1993 memorandum to Respondent 1. In fact, the Branch Manager referenced the letter in the memorandum. Although the Branch Manager contended at the DBCC hearing that he had not received a copy of the Firm C due diligence file, the foregoing demonstrates that he, in fact, had obtained a copy of the "hold harmless" letter prior to being given the Firm C due diligence file by the Firm. We note that there is record evidence that the "hold harmless" letter was contained in the Firm C due diligence file. We further note that there is no explanation in the record for the seemingly inconsistent statements made by the Branch Manager about when he received the Firm C due diligence file that contained a copy of the "hold harmless" letter. In any event, the due diligence file did not constitute sufficient notice to satisfy the requirements of Rule 3040.

[5] Respondent 1 argued that the Company A memorandum, which listed names of persons that had received Company A offering memoranda between January 1 and January 14, 1994, was probative of the Branch Manager's knowledge about Respondent 1's sales activities because it shows that he sent Company A offering memoranda to two individuals who worked for the same firm (Firm D) as the Branch Manager's son. Respondent 1 also argued that documents related to a purchase of a Company A promissory note in a Firm B IRA account showed that the Branch Manager and the Firm's regional legal counsel knew of his activities with respect to Company A. We find that these documents do not prove that the Branch Manager and the Firm's regional legal counsel knew the extent of Respondent 1's involvement in Company A. Furthermore, the Branch Manager's and the Firm's regional legal counsel's knowledge here is

charged with having knowledge of the rules regarding the private sales of securities. See Carter v. S.E.C., 726 F.2d 472 (9th Cir. 1983). Accordingly, it was Respondent 1's responsibility to provide the Firm with written notice meeting the requirements of Conduct Rule 3040. The Employee Reporting Statement that Respondent 1 completed and signed on August 13, 1993, provided no details about his participation or role in the Offering;[6] therefore, it cannot be considered as evidence of prior written notice.[7]

Unlike the DBCC, we decline to decide whether Respondent 1's participation in the private placement offering was for compensation. Conduct Rule 3040(b) provides that the requisite written notice by an associated person prior to participating in a private securities transaction should state whether that person has or will receive selling compensation in connection with the transaction. Transactions for compensation require the firm to advise the associated person in writing whether it approves or disapproves of the person's participation in the proposed transaction, while transactions not for compensation require the firm to provide the associated person with written acknowledgment of the notice.[8] Therefore, although the issue of selling compensation is determinative of the type of notice that a firm must give to an associated person who provides written notice prior to participating in a transaction, it is irrelevant for purposes of determining whether or not an associated person has violated Conduct Rule 3040. Accordingly, we need not reach the issue of whether the compensation that Respondent 1 received under the consulting agreement was related to his participation in Company A's second offering.

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irrelevant because Rule 3040 placed the duty on Respondent 1 to provide the Firm with prior written notice about his activities.

[6] The Employee Reporting Statement indicates that Respondent 1's affiliation with Company A would require one hour of his time per day, yet the record testimony shows that it was common knowledge in the branch office that Respondent 1 was spending considerably more time on Company A matters than one hour per day. The record testimony indicates that Respondent 1 was spending virtually all of his time on Company A matters. Considering the testimony about the importance of Company A to Respondent 1 and the fact that he would be devoting a lot of time to Company A his first year with Firm B, it appears to us that, at a minimum, the Branch Manager had a duty to alert Firm B to the fact that Respondent 1was spending much more time than the one hour per day on Company A matters that he had noted on the form.

[7] It appears that the Employee Reporting Statement was designed to satisfy the requirements of Conduct Rule 3030, which provides that an associated person must give written notice to a member about outside business activities for which the person is compensated. The Employee Statement did not ask about Respondent 1's proposed role with Company A and Respondent 1 provided no such information.

[8] See Subsections (c) and (d) of Conduct Rule 3040, respectively.

Sanctions

We affirm the sanctions imposed by the DBCC. With respect to the principal considerations listed in the Sanction Guidelines ("Guidelines") for selling away (private securities transactions), we find that: (1) Respondent 1 participated in several presentations to potential investors during the period of the offering, which was from September 30 through December 31, 1993; (2) Respondent 1 held a 12.9% beneficial interest in Company A; (3) to the extent Respondent 1 thought that certain documents had been provided to the Branch Manager and that those documents were sufficient notice, it does not appear that he wilfully disregarded the requirements of Conduct Rule 3040; and (4) Respondent 1 did not attempt to conceal the "selling away" activity. For the above reasons, we believe that the minimum monetary sanction under the applicable Guidelines is an appropriate remedial measure and that a suspension therefore is not necessary.[9]

Based on the following facts, we conclude that it is likely that the Branch Manager knew that Respondent 1 was participating in sales efforts with respect to Company A: (1) the testimony of Respondent 1, the Branch Manager, Respondent 1's assistant, and another employee who all worked in Firm B's branch office, about the extent of Respondent 1's involvement with Company A; (2) the evidence in the record that Respondent 1 was not spending much time on Firm B-related activities; (3) testimony from Respondent 1's assistant that Company A private placement memoranda were kept in a visible place on her desk, in light of evidence in the record that the branch office was a relatively small branch office; and (4) testimony from the Branch Manager and Respondent 1 that the Branch Manager knew Respondent 1 was involved with sales in connection with the first offering, and that there would be another offering because Company A only had raised one third of the necessary capital in the first offering. Although Respondent 1 had reasonable grounds to believe that Firm B knew about his sales efforts in connection with Company A, we find that such belief did not obviate Respondent 1's duty to provide the Firm with the proper written notice.

Conclusion

In summary, we affirm the findings of the DBCC and the sanctions imposed. Thus, Respondent 1 is censured, fined $5,000, and assessed $1,985.25 in hearing costs.[10]

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[9] See NASD Sanction Guidelines (1996 ed.) at 45 (Selling Away (Private Securities Transactions)).

[10] We have considered all of the arguments of the parties. Such arguments 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. In addition, Respondent 1 is assessed NBCC hearing costs of $750.

On Behalf of the National Business Conduct Committee,

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Joan C. Conley, Corporate Secretary