

PLEASE NOTE THE LATER CASE HISTORY OF THIS DECISION FOLLOWING THE TEXT OF THE DECISION.

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of the Association
of
X
as a
General Securities Principal Municipal Securities Principal and Government Securities Principal
with
The Sponsoring Firm

Redacted Decision

Notice Pursuant to
Section 19h-1
Securities Exchange Act
of 1934

Decision SD99025

On June 28, 1999, a member firm ("the Sponsoring Firm" or "the Firm") completed an MC-400 application ("Application") to permit X¹, a person subject to a statutory disqualification, to associate with the Firm as a general securities principal, municipal securities principal, and government securities principal. The Sponsoring Firm also proposes that X would have a 22 percent ownership interest in Company 1, the sole general partner of the Sponsoring Firm, which owns one percent of the Firm. In September 1999, a subcommittee ("Hearing Panel") of the Statutory Disqualification Committee of NASD Regulation, Inc. ("NASD Regulation") held a hearing on the matter. X appeared and was accompanied by his proposed supervisor, the President and CEO of the Sponsoring Firm ("the Proposed Supervisor"). BA appeared on behalf of the Department of Member Regulation ("Member Regulation").

X's Statutorily Disqualifying Event and Background. X is subject to a statutory disqualification as a result of a 1997 Order issued by the Securities and Exchange Commission ("SEC" or "the Commission") that settled administrative proceedings instituted against X pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("the Exchange Act"). The Order found that during the

¹ The names of the Statutorily Disqualified individual, the Sponsoring Firm, the Proposed Supervisor, and other information deemed reasonably necessary to maintain confidentiality have been redacted.

relevant period, X held significant responsibility for making major decisions regarding the management and direction of Firm A, a firm for which he served as Executive Vice President, Chief of Staff, Compliance Director, general securities principal, and director. The SEC determined that from 1989 through 1993, five persons associated with Firm A (other than X) willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act, and SEC Rule 10b-5 thereunder. The Commission found that these five individuals had made material misrepresentations and had failed to disclose material information to investors in connection with numerous sales to public customers of derivatives of collateralized mortgage obligation securities ("CMOs"), including interest-only strips ("IOs"), inverse IOs, and inverse floater CMOs.²

The Order found that X had failed reasonably to supervise the Firm A representatives and other employees who were subject to his supervision, and that he had failed to correct inadequate supervisory policies and procedures at Firm A that persisted for a significant time. The Order also noted that there were ample "red flags" that were sufficient to alert X that Firm A's compliance and supervisory policies were inadequate and to place any reasonable supervisor on notice of the possibility of violations of the federal securities laws.

X was sanctioned by the SEC as follows: 1) a six-month suspension in all capacities from association with any broker, dealer, municipal securities dealer, investment adviser or investment company; 2) a bar from association with the same entities in any supervisory capacity, with the right to reapply after one year; and 3) a \$15,000 fine. In addition, the 22 percent ownership interest that X had in Company 1 stock was transferred, on the effective date of X's SEC suspension and bar, to a Blind Trust.³ X paid the fine and served the suspension; the one-year supervisory bar period ended in 1999.

X was a general securities representative with Firm A from January 1988 through July 1996. He became a general securities representative with the Sponsoring Firm in July 1996, and he passed the general securities principal and municipal securities principal examinations in 1996. As a result of the SEC action discussed above, X terminated his employment at the Sponsoring Firm in 1997. Following the conclusion of his six-month suspension in all capacities in 1998, X has acted as a consultant to the Sponsoring Firm and other firms.

In addition to the 1997 SEC Order, the Central Registration Depository ("CRD") shows that in 1995, an arbitration was filed against X, Firm A, and other individuals, which arose from the same

² The five individuals failed to disclose to the investors that CMO derivatives are extremely sensitive to changes in interest rates and prepayment speeds, thus subjecting the investors to risks including loss of principal and illiquidity. The investors also were falsely told that the CMO derivatives were Fannie Mae or Freddie Mac securities guaranteed by the government.

³ The Sponsoring Firm proposes that if its Application is approved, within 30 days the Trustee of the Blind Trust will transfer the Company 1 Units to an Individual Retirement Account ("IRA") for the benefit of X.

misconduct that led to the SEC supervisory bar against X. The parties settled and the claimants were provided with a guaranteed rate of return on certain securities purchased by the claimants from Firm A.⁴ X did not contribute to this settlement, and he was released from any liability for the misconduct alleged in the arbitration.

In 1991, a civil complaint was brought against Firm A and six officers of the company, including X, alleging misrepresentation and omission of material facts in the sale of unregistered securities. The plaintiffs settled with Firm A for \$20,000 and a release. X has represented that Firm A had sold the securities in question to another broker/dealer, and that he had no contact with the plaintiffs. He has asserted that he was named in the complaint solely because he was a corporate officer of Firm A.

The Sponsoring Firm. The Sponsoring Firm was admitted to membership in the Association in 1991. In 1996, the Sponsoring Firm acquired all of Firm A's assets. Firm A filed a Form BDW to withdraw from registration as a broker/dealer, and all of the people who had been associated with Firm A moved to the Sponsoring Firm. The Sponsoring Firm is engaged in the general securities brokerage business. In addition to sales and trading of taxable and municipal fixed-income securities, the Sponsoring Firm conducts a municipal finance practice and engages in wholesale equity market-making activities with other dealers.

A 1999 routine examination of the Sponsoring Firm has not been assigned. The 1998 routine examination resulted in a Compliance Conference regarding several issues, including inaccurate net capital computations, failure to forward funds to customers promptly, failure to file Forms G-36 timely, and failure to report promptly to the Association three settlements of claims for damages. By letter dated June 22, 1999, the Sponsoring Firm responded to the Association's concerns and outlined the actions that it had taken with respect to the deficiencies noted at the Compliance Conference.

In 1998, NASD Regulation accepted an AWC from the Sponsoring Firm for failing to comply with MSRB Rule G-36 by timely providing copies of its final official statements and completed Forms G-36. The Sponsoring Firm was censured and fined \$3,000.

In 1997, two SD examinations were Filed Without Action for Employee 1 and Employee 2. Employee 1 is no longer associated with the Sponsoring Firm. Employee 2, who had been the President and sole owner of Firm A, was recently permitted to associate with the Sponsoring Firm pursuant to the filing by NASD Regulation of an SEC Rule 19h-1 "short form" notification, dated in 1999.⁵

⁴ We do not know the exact value of this settlement, but we note that Firm A provided the claimants with Letters of Credit worth \$500,000 to secure the guarantee.

⁵ Employee 1 initially was subject to a statutory disqualification as a result of a 1995 Order of Permanent Injunction of State 2 that had resulted from the same activity that led to X's SEC Order. Employee 1 was prohibited from selling or offering to sell certain CMO mortgage-backed derivative securities for various periods of time, and he was not permitted to open any new customer accounts for

In 1995, the Sponsoring Firm entered into a consent order settlement with the State 1 Securities Division for effecting 11 transactions in a non-institutional account before being registered in that State. The Sponsoring Firm was fined \$680 and ordered to notify its State 1 customers of possible rescission rights.

The Proposed Supervisor and X's Proposed Duties. The Sponsoring Firm proposes that the President and Chief Operating Officer ("COO") would be X's supervisor ("Proposed Supervisor"). The Proposed Supervisor is the President and COO of the Sponsoring Firm. He was one of the Sponsoring Firm's founders, and he has been the President, COO, and Chief Financial Officer ("CFO") since 1992. The Proposed Supervisor has been a general securities principal since 1990 and he has no disciplinary history.⁶

The Sponsoring Firm proposes to employ X as a municipal securities principal and general securities principal at the Firm's home office. He would be employed as the chief government securities principal, and as Administrative Officer of the Sponsoring Firm and would report to the President and CEO. The following departments within the Sponsoring Firm would report to X: administration, operations, personnel and benefits administration, information systems, plant, and general services.

X's duties with respect to administration would include: Compliance Officer, reporting to the Chief Compliance Officer; Firm liaison with regulatory bodies; NASD executive representative; Firm liaison with outside counsel; litigation management; contract administration; Firm-wide policies and procedures (including drafting proposed policies for operating committee approval), ongoing evaluation and maintenance of the Sponsoring Firm's supervisory, compliance, personnel and other policies and procedures; and secretary of Company 1 (the sole general partner of the Sponsoring Firm) and to the Operating Committee. With respect to operations, X's duties would include overall planning for and

one month. Employee 1's association as a registered representative with the Sponsoring Firm was the subject of a Notice pursuant to SEC Rule 19h-1 filed by the NASD in 1996, and approved by the Commission in 1997. In the SEC action that resulted from the same activity that formed the basis for Employee 1's State 2 Injunction, Employee 1, like X, accepted the Commission's offer of settlement in 1997, fining him \$50,000, suspending him from the securities industry in all capacities for 12 months, and barring him for three years as a supervisor with a right to reapply at the expiration of three years. Due to the SEC Order, the Sponsoring Firm filed a Form U-5 on Employee 1's behalf. When the period of Employee 1's suspension in all capacities expired, the Sponsoring Firm filed another membership continuance application on behalf of Employee 1 to permit him to associate with the Sponsoring Firm once again, but only in a registered representative capacity.

⁶ The Proposed Supervisor has reported to the CRD that when he was Executive Vice President of a savings and loan association, it was placed under supervisory control in 1988, placed in receivership in 1989, and taken over by the FDIC. The Proposed Supervisor represents that the association failed due to bad real estate loans and that there were no allegations, charges, or disciplinary actions taken against him.

oversight of the Sponsoring Firm's operations functions. In terms of personnel, he would have overall responsibility for the Sponsoring Firm's personnel policies and procedures, including research, evaluation and administration of employee benefits. His information systems duties would include planning, budget and overall oversight of the Sponsoring Firm's information technology function, including communications, electronic interfaces and third-party vendors. X's duties with respect to plant and general services would encompass lease administration, liaison between building management and the Sponsoring Firm; and handling facility administration and other services.

The Sponsoring Firm represents that X would not be permitted to offer or sell securities. He also would not supervise any registered representatives, including any sales- or trading-related activities of any registered representatives. He would be paid a base salary, and would participate in an administrative bonus pool consistent with the manner of compensation of the Sponsoring Firm's other salaried, administrative employees.

Member Regulation's Recommendation. Member Regulation recommends that X's association with the Sponsoring Firm be approved subject to the enhanced supervision of X that the Sponsoring Firm has proposed.

Discussion. After careful review of the entire record in this matter, we conclude that the Sponsoring Firm's Application to employ X as a general securities, municipal securities, and government securities principal should be approved.

In reaching this determination, we have considered that in 1997, when the SEC imposed the supervisory bar on X with the right to reapply after one year, the Commission was charged with weighing the requirements of the public interest in light of X's misconduct. The Commission concluded that it was appropriate to allow X to apply for association with a broker/dealer in a supervisory capacity after one year. Accordingly, in reviewing this Application, NASD Regulation must follow the guidance supplied by the SEC in In re Paul Van Dusen, 47 S.E.C. 668 (1981). Van Dusen tells us that, in Commission enforcement actions in which a right to reapply is specified, an application submitted after the specified term should be granted, absent other acts of misconduct or circumstances of record bearing adversely on a firm or a sponsored person's fitness to re-enter the securities industry. In order to deny approval where a right to reapply has been granted, the NASD is prohibited from considering any factors apart from "other [intervening] misconduct in which the applicant may have engaged, the nature and disciplinary history of a prospective employer, and the supervision to be accorded the applicant." Van Dusen, at 671.

The record does not reveal any intervening misconduct by X after the entry of the SEC's Order. As to the Sponsoring Firm's disciplinary history, we note that the State 1 Consent Order, the 1998 AWC, and the 1999 Compliance Conference are relatively minor disciplinary incidents. We do not find that these incidents are severe enough to raise regulatory concern over the Sponsoring Firm's ability to supervise X. None of the Sponsoring Firm's disciplinary history involved supervisory lapses. Further, the Proposed Supervisor appears to be fully capable of providing the requisite level of heightened

supervision to be accorded a statutorily disqualified person because of his extensive experience in public accounting and the securities industry. The Proposed Supervisor also has no disciplinary history.

Given the terms of X's 1997 settlement with the Commission, we have determined that under the requirements of the Commission's decision in Van Dusen, the Sponsoring Firm's Application satisfies the conditions necessary for X to re-enter the securities industry.

We therefore conclude that the Sponsoring Firm and the Proposed Supervisor are qualified to supervise X and that they have proposed an effective plan of supervision. The Sponsoring Firm will implement the following supervisory procedures:

1. The Sponsoring Firm's supervisory procedures will be amended to establish clearly that the Proposed Supervisor is X's responsible supervisor;
2. X will not be permitted to offer or sell, or supervise the offer or sale of, any securities; provided, however, that he will be permitted to evaluate, assess and maintain the Sponsoring Firm's overall supervisory and compliance policies and procedures;
3. Copies of all of X's incoming and outgoing correspondence will be forwarded to the Proposed Supervisor for review;
4. The Proposed Supervisor will keep a written record evidencing review and approval of all of X's correspondence;
5. The Proposed Supervisor must certify quarterly (March 31st, June 30th, September 30th, and December 31st) in a memo to a file that all of the above conditions of heightened supervision to be accorded X are being complied with; and
6. For the duration of X's statutory disqualification, the Sponsoring Firm must obtain prior approval from Member Regulation if it wishes to change X's supervisor from the Proposed Supervisor to another person.

NASD Regulation certifies that: 1) X meets all applicable requirements for the proposed employment; 2) the Sponsoring Firm is not a member of any other self-regulatory organization; and 3) X and the Proposed Supervisor have represented that they are not related by blood or marriage.

Accordingly, in conformity with the provisions of SEC Rule 19h-1, the association of X as a general securities principal, a municipal securities principal, and a government securities principal of the Sponsoring Firm will become effective upon the issuance of an order by the Commission that it will not institute proceedings pursuant to Section 15A(g)(2) of the Act. The NASD is also seeking relief under Section 19(h) of the Act. This notice shall serve as an application for such an order.

On Behalf of the National Adjudicatory Council,

Joan C. Conley
Senior Vice President and Corporate Secretary

LATER CASE HISTORY:

After this notice was filed with the SEC but before it was approved by the SEC, the SEC asked for certain additional information. To that end, the Sponsoring Firm represented the following:

- X will be a member of the Sponsoring Firm and of the Sponsoring Firm's operating committee; X will be Chief Administrative Officer, reporting to the President and the CEO. The following functions within the Sponsoring Firm will report to X: administration, operations, personnel and benefits administration, information systems, plant and general services.
- X will be responsible for: Administration: contract administration; secretary to the Sponsoring Firm and its operating committee. Operations; overall planning for and oversight of the Sponsoring Firm's operations functions. Personnel: overall responsibility for the Sponsoring Firm's personnel policies and procedures, including research, evaluation and administration of employee benefits. Information Systems: planning, budget and overall oversight of the Sponsoring Firm's information technology function, including communications, electronic interfaces and third-party vendors. Plant and General Services: lease administration; liaison between building management and the Sponsoring Firm; facility administration; other office services. Limitations: X will not be permitted to sell or offer to sell securities; X will not supervise any registered representatives; X will not supervise any sales or trading related activities of any registered representatives; X will not be responsible for any aspect of the Sponsoring Firm's compliance function.

Based on these representations, as well as the representations set forth in the December 23, 1999 notice, the SEC approved X's association with the Sponsoring Firm.