

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of

Department of Market Regulation,

Complainant,

vs.

Ko Securities, Inc.

and

Terrance Yoshikawa

Respondents.

DECISION

Complaint No. CMS000142

Dated: December 20, 2004

On remand from the Securities and Exchange Commission for reconsideration of sanctions. Held, sanctions affirmed.

Appearances

For the Complainant: Jeffrey K. Stith, Esq., NASD Department of Market Regulation, Rockville, MD

For the Respondent: Terrance Yoshikawa, Seattle, WA, pro se.

DECISION

I. Background

This matter is before us on remand from the Securities and Exchange Commission. In a National Adjudicatory Council ("NAC") decision dated November 13, 2002 ("NAC Decision"), we found that Ko Securities, Inc. ("Ko Securities" or "the Firm") and Terrance Yoshikawa ("Yoshikawa") (together, "the respondents") violated: (1) NASD Conduct Rules 3370 and 2110 by executing short sales without making and annotating the affirmative determinations¹ required

¹ NASD Conduct Rule 3370(2)(A) states that "[n]o member or person associated with a member shall accept a 'short' sale order . . . in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security . . . by [the] settlement date." In order to comply with this rule, it is

[Footnote continued on next page]

for each short sale; and (2) Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-3² and NASD Conduct Rule 2110³ by failing to maintain adequate records for such short sales. We fined the respondents \$147,450.81,⁴ jointly and severally, for the affirmative determination violation, and we fined Ko Securities \$15,000 individually for the recordkeeping violation. The respondents appealed the NAC Decision to the Commission. On appeal, the Commission remanded the matter to NASD for reconsideration of sanctions for the short sale violations.

II. Procedural History

NASD's Department of Market Regulation ("Market Regulation") filed a complaint on July 5, 2000, alleging that the respondents failed to make and annotate affirmative determinations for short sales. The complaint also alleged that Ko Securities violated Regulation T, failed to properly identify customer sell order tickets as short sales, and failed to maintain required records of brokerage orders. The respondents filed an answer to the complaint and requested a hearing, which was held in Seattle, Washington, on May 30 and 31, 2001, before a Hearing Panel. On October 15, 2001, the Hearing Panel issued a decision finding that the respondents had engaged in the misconduct alleged in the complaint except for the alleged Regulation T violation.

The respondents appealed the Hearing Panel Decision and Market Regulation filed a cross-appeal challenging the sufficiency of the sanctions imposed by the Hearing Panel. On May 22, 2002, a NAC subcommittee heard oral argument from the parties in Seattle, Washington. On November 13, 2002, we issued a decision affirming the findings and sanctions imposed by the Hearing Panel. The respondents sought review of this decision before the Commission, and in a decision dated September 26, 2003 ("SEC Decision"), the Commission sustained our findings of liability for each violation and also sustained the \$15,000 fine we imposed on respondents for the recordkeeping violation. The Commission, however, remanded the matter to NASD for consideration of whether the \$147,450.81 fine imposed for the short sale violations was appropriate. Specifically, the Commission requested that we clarify the basis for adding \$145,450.81 in profits made by the respondents to the \$2,000 fine we imposed for the NASD Conduct Rule 3370 violation.

[cont'd]

common for the short selling member or person associated with the member to obtain a commitment from a clearing firm that shares will be available to borrow by the settlement date.

² SEC Rule 17a-3 requires that registered broker-dealers shall make and keep accurate books and records relating to certain enumerated aspects of the broker-dealer's business.

³ NASD Conduct Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

⁴ This fine constituted a \$2,000 base fine plus \$145,450.81 — an amount equal to the respondents' profits from the short sales.

III. Facts

The key facts relating to the short sale violations are undisputed. On April 21, 1998, NASD issued a Letter of Caution against the respondents for their failure to comply with NASD Conduct Rule 3370's affirmative determination requirement. NASD issued the April 1998 Letter of Caution because respondents had received affirmative determinations to borrow stock from their clearing firm's stock loan department, but had failed to keep records of the affirmative determinations. Yoshikawa testified that he did not believe that NASD's rules governing short sales were clear on how to satisfy NASD's affirmative determination requirement. Yoshikawa further testified that he had misgivings about asking NASD staff for assistance interpreting these rules because it was likely to result in an investigation of the Firm.

Approximately three weeks later, on May 4, 1998, the respondents made 82 short sales involving more than 58,000 shares of Entremed, Inc. ("Entremed") stock.⁵ In violation of NASD Conduct Rule 3370's affirmative determination requirement, the respondents made these sales without first determining whether they would be able to borrow enough shares of Entremed stock to cover the short sales. Respondents admitted that around the time that they began selling the Entremed shares short, they asked Paine Webber⁶, whether they could borrow Entremed shares to cover their short sales. Respondents also admitted that they began short-selling the Entremed shares prior to determining whether Paine Webber would actually agree to lend them the Entremed shares. Finally, respondents conceded that after Paine Webber denied their request to borrow Entremed shares, respondents continued short-selling the Entremed shares and did not make any attempt to locate another dealer from which they could borrow the shares needed to cover their short sales.

Respondents argued that NASD Conduct Rule 3370 did not require them to determine whether they would be able to borrow enough Entremed shares prior to selling the stock short. Respondents claimed that they could satisfy NASD Conduct Rule 3370's affirmative determination requirement if they purchased enough Entremed shares by the end of the day to cover their short sales. Respondents also claimed that other NASD member firms executed short sales in this manner and that they believed it was therefore permissible for them to do so.

In the end, Yoshikawa and Ko Securities made a net profit of \$9,806.66 and \$135,644.15, respectively, from the Entremed short sales. In addition, these short sales generated \$394,012.58 in profits that were distributed to 14 customer accounts owned by the Firm's employees and their relatives. Respondents maintained that they complied with NASD

⁵ Entremed is a biopharmaceutical company that was developing a product, which it described as "inhibit[ing] abnormal blood vessel growth associated with a broad range of diseases such as cancer, blindness, arthritis and atherosclerosis."

⁶ Correspondent Services Corporation, a Paine Webber affiliate, was the respondents' clearing firm during the relevant period. For the purposes of this opinion, the respondents' clearing firm shall be referred to as Paine Webber.

Conduct Rule 3370's affirmative determination requirement by purchasing enough Entremed shares by the end of the day to cover the Firm's short sales.

IV. Discussion

In the NAC Decision, we determined that the respondents made a \$145,450.81 profit from short sales that the Firm executed without first making the required affirmative determinations. The \$147,450.81 fine we imposed for the affirmative determination violation represented a \$2,000 base fine plus a \$145,450.81 fine equal to the amount of the respondents' profits from the short sales. The Commission objected to our inclusion of the profits from the short sales as part of the fine. Specifically, the Commission found that we could not include the short sale profits as part of the fine since we did not conclude that the respondents' misconduct was either willful or egregious.

On remand, we find that specific findings of willfulness or egregiousness regarding the short sale violations are not necessary for us to impose a fine that includes the amount of the respondents' financial benefit from such short sales. This is because the SEC has expressly acknowledged NASD's power to order the disgorgement of ill-gotten gains from its membership, and NASD's power is not limited only to instances in which a respondent's misconduct is willful or egregious. See Patten Sec. Corp., 51 S.E.C. 568, 579 (1993); Michael David Sweeney, 50 S.E.C. 761, 768 (1991). Nevertheless, we find that respondents' failure to make the required affirmative determinations for their short sales in this case was willful. We also find that there are a number of aggravating factors associated with the respondents' misconduct that support our decision to impose a fine that includes the profits received by the respondents for the improper short sales.

A. *Respondents Willfully Violated NASD Conduct Rule 3370*

In order to commit a willful violation, a respondent need only have intentionally committed the act that constitutes the violation. See Arthur Lipper Corp., 547 F.2d 171, 180 (2d Cir. 1976); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965); James E. Ryan, 47 S.E.C. 759, 761 n.9 (1982). Here, respondents admit that on May 4, 1998, they deliberately executed 82 short sales of Entremed stock without first making the affirmative determinations required under NASD Conduct Rule 3370. Respondents sold the Entremed stock short when they knew that their clearing firm would not loan them any shares to cover these short sales. Moreover, after discovering that their clearing firm would not loan them any Entremed stock, respondents sold Entremed shares short without trying to find another dealer to cover the sales. Consequently, there is no dispute that respondents intentionally committed the acts that constitute a violation of NASD Conduct Rule 3370.

B. *Respondents' Erroneous Interpretation of NASD Rules Does Not Preclude a Finding of Willfulness*

We reject respondents' argument that they did not willfully violate NASD Conduct Rule 3370 because they erroneously believed that they had complied with the rule by purchasing enough Entremed stock by the end of the day to cover the Firm's short sales. As a matter of law,

the respondents are presumed to know and understand NASD's Rules.⁷ Moreover, there is no requirement that an individual must know that his conduct violates an NASD rule in order to support a finding that he willfully violated the rule.⁸ We therefore find that when respondents sold the Entremed shares short prior to making an affirmative determination as to whether they could borrow shares to cover these short sales, they willfully violated NASD Conduct Rule 3370.

V. Sanctions

NASD's Sanction Guidelines ("Guidelines") recommend a base fine of \$1,000 to \$2,000 for short sale violations.⁹ The Guideline for short sale violations also allows us to "increase the recommended fine amount by adding the amount of a respondent's financial benefit"¹⁰ and does not require a finding of willfulness in order for such an increase.¹¹ Furthermore, the general principles applicable to all violations state that the disgorgement or "fining away" of a respondent's gains resulting from his misconduct is permissible where appropriate to remediate

⁷ See Carter v. SEC, 726 F.2d 472, 474 (9th Cir. 1983); see also Dist. Bus. Conduct Comm. v. Pan Oceanic Invs., Inc., Complaint No. SF-1256, 1990 NASD Discip. LEXIS 26, at *41 (Bd. of Governors Feb. 28, 1990) (stating that a broker-dealer is held to know the rules pursuant to which it operates).

⁸ See Dep't of Enforcement v. Knight, Complaint No. C10020060, 2004 NASD Discip. LEXIS 5, at *10 (NAC Apr. 27, 2004) (stating that to support a finding that respondent acted willfully, the NAC need only find that respondent intended to commit the act that constituted the violation); cf. Wonsover v. SEC, 205 F.3d 408, 413-14 (D.C. Cir. 2000) (affirming the SEC's finding of respondent's willful violation under section 15(b)(4) of the Exchange Act even though there was neither an intent to violate the law nor a reckless disregard of a regulatory requirement by respondent).

⁹ In addition, the Guidelines allow us to "[add] the amount of the short-selling customer's transaction profit to the fine" if the violation is egregious or if the violation involves willful misconduct. See Guidelines (2001 ed.), at 70 (emphasis added).

¹⁰ See Guidelines (2001 ed.), at 70 n.1.

¹¹ The Guideline for short sale violations only requires a showing of willfulness if respondents' customers — rather than the respondents themselves — realized profits from the short sales and we included these profits in the respondents' fine. See Notice to Members 01-27 (Apr. 2001) (NASD revised the monetary sanction of the short sales guideline to account for profits made by a short selling customer who did not execute the short sales and is not subject to NASD jurisdiction. In certain cases, NASD determined that it may be appropriate to add the short selling customer's transaction profits to a fine imposed on the NASD member or associated person who executed the sales on the short selling customer's behalf).

such misconduct.¹² The general principles do not restrict NASD's ability to increase a fine by the amount of a respondent's profit to cases involving egregious or willful misconduct.

The SEC has expressly acknowledged NASD's power to order the disgorgement of ill-gotten gains from its members. See Patten, 51 S.E.C. at 579. NASD's disgorgement policy requires a respondent to surrender the gains derived from his misconduct so that he does not profit from his violations. Id. The SEC has instructed NASD to order disgorgement in "all cases in which the NASD can identify direct financial gain obtained by a wrongdoer as a result of his or her wrongful activities." Sweeney, 50 S.E.C. at 768.

Here, we have identified \$145,450.81 that respondents have gained from executing the Entremed short sales without obtaining an affirmative determination that they could cover the short sales. Respondents violated NASD Conduct Rule 3370 by executing the Entremed short sales in this manner, and if the respondents retain the \$145,450.81, they will profit significantly from their violation. It is therefore appropriate for us to include the respondents' profits in the fine imposed for their violations.

The Guideline for short sale violations specifies that we may increase the recommended fine by adding the amount of a respondent's financial benefit to the fine. The Guidelines, however, also list a number of "principal considerations" that adjudicators should generally consider in conjunction with the imposition of sanctions in addition to those which may be specified for particular violations.¹³ Under these principal considerations, there are additional aggravating factors that support the fine we imposed on the respondents for their short sale violations.

One aggravating factor is that the respondents' misconduct involved a significant amount of money. Respondents made 82 short sales involving 58,600 shares of stock. These trades generated more than \$145,000 in profits for respondents as well as almost \$400,000 in profits for the Firm's employees and family members. Imposing only a \$2,000 base fine on respondents would fail to account for the number, size, and character of the short sale transactions as well as the profits that respondents realized from their misconduct.

In addition, approximately three weeks before their short sale violations, NASD sent the respondents a Letter of Caution for their failure to satisfy NASD's affirmative determination requirements. The respondents assert that NASD's affirmative determination requirements were unclear, but respondents made no effort to seek assistance from NASD to aid their understanding of these requirements. In fact, respondents showed indifference to NASD's regulatory authority by intentionally refusing to seek NASD's advice on how to comply with its requirements. Instead, respondents chose to rely on the interpretations of NASD procedures adopted by third parties. Even if respondents initially believed their practices and the practices of third parties

¹² See Guidelines (2001 ed.), at 7.

¹³ See Guidelines (2001 ed.), at 9-10.

were in compliance with NASD's procedures, respondents should have been aware that they needed to take greater steps to ensure compliance with NASD's affirmative determination requirements once they received NASD's Letter of Caution. Instead, respondents ignored this warning and violated NASD's short sale rule.

In sum, we find that both our disgorgement policy and our consideration of the aggravating factors in this case support a fine that includes the amount of profits realized by respondents because of their short sale violations.¹⁴

VI. Conclusion

Accordingly, the respondents are fined \$147,450.81, jointly and severally, for their short sale violations.¹⁵

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

¹⁴ We have also considered and reject without discussion all other arguments advanced by the parties.

¹⁵ Pursuant to NASD Procedural Rule 8320, any member that 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.