NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. DOUGLAS CONANT DAY (CRD No. 1131612), San Jose, CA, Respondent.	Disciplinary Proceeding No. C01020024 Hearing Officer—Andrew H. Perkins **HEARING PANEL DECISION** November 24, 2003

Respondent found liable for (1) failing to respond to requests for information in violation of Conduct Rule 2110 and Procedural Rule 8210; (2) making unsuitable recommendations in violation of NASD Conduct Rules 2110 and 2310(a). Respondent barred from associating with any NASD member firm in any capacity for each violation. In addition, Respondent is fined a total of $125,000, which fines are due and payable if and when the Respondent re-enters the securities industry, and is ordered to pay restitution in the sum of $79,500.

Appearances

For the Department of Enforcement: David A. Watson, Regional Counsel, San Francisco, CA (Rory C. Flynn, Chief Litigation Counsel, Washington, DC, Of Counsel).

For the Respondent: Douglas Conant Day appeared on his own behalf.

DECISION

I. INTRODUCTION

The Department of Enforcement (the "Department") brought this disciplinary proceeding against the Respondent Douglas Conant Day ("Day" or the "Respondent") charging that he violated NASD Conduct Rules 2310(a) and 2110 by making unsuitable recommendations to four customers, and that he violated NASD Conduct Rule 2110 and NASD Procedural Rule 8210 by providing false information to NASD Staff during the course of the investigation that led to the filing of the Complaint in this proceeding. NASD has jurisdiction of this proceeding because the Respondent was registered as a General Securities Representative at the time of the alleged violations and when the Department filed the Complaint.[1]

For the reasons discussed below, the Hearing Panel found that the Respondent committed the alleged violations and ordered therefore that he be barred from associating in any capacity with an NASD member firm.

II. PROCEDURAL BACKGROUND

The Department filed the Complaint against Day on December 11, 2002. Day filed an Answer on January 30, 2003, denying the charges and requesting a hearing. Accordingly, the Hearing Officer ultimately set the case for hearing on August 13, 2003, in San Francisco before a hearing panel comprised of the Hearing Officer and two current members of NASD District 1 Committee.

[1] *See* NASD By-Laws, Art. V, Sec. 4.

On August 6, 2003, the Hearing Officer conducted a final pre-hearing conference. During the conference, the Respondent stated that he did not intend to attend the hearing or participate further in his defense. The Hearing Officer advised the Respondent that should he fail to appear he could be found in default, in which case the allegations in the Complaint could be taken as admitted. Then, following a discussion of his options, the Respondent waived his right to a hearing. Consequently, the Hearing Officer canceled the hearing and informed the Parties that the Hearing Panel would decide the case based upon the record.

On August 7, the Department filed a request to supplement the record, which the Hearing Officer granted. The Hearing Officer set a deadline of September 5 for the Department to file any further papers in support of the Complaint and a deadline of September 26 for the Respondent to file a response. The Department filed a Supplemental Memorandum and the Declaration of Linda Maniwa ("Maniwa Decl."), an NASD Compliance Examiner in NASD's San Francisco office. The Respondent did not submit any materials in his defense.

III. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. The Respondent

According to Day's Central Registration Depository ("CRD") record, Day started in the securities industry in 1983.[2] In September 1988, he formed Day International

[2] Ex. C–2. (The Department submitted 22 exhibits with its Pre-Hearing Submissions and Exhibit 23 with Maniwa's Declaration.)

Securities, which was a member of NASD from July 1989 until February 26, 2003.[3] Day was its President.[4]

While associated with Day International, the Respondent was registered as a General Securities Representative, an Investment Company and Variable Contracts Products Representative, an Investment Company and Variable Contracts Products Principal, and an Introducing Broker-Dealer/Financial and Operations Principal.[5] Each of Day's registrations terminated effective January 13, 2003.[6]

B. Unsuitable Recommendations

The first and second causes of action allege that Day recommended that two couples purchase unsuitable securities. In the first, the Complaint alleges that, in or about October 1999, Day recommended that LO and DO purchase an "investment contract" offered by World Cash Providers, LLC ("World Cash").[7] In the second, the Complaint alleges that Day, in or around February 2000, recommended that KS and DS purchase an "investment contract" offered by Mobile Cash Systems, L.L.C. ("Mobile Cash Systems"). In form, the documents attempted to cloak the investments as purchases of equipment. World Cash purportedly sold LO and DO twenty "cash ticket machines," and Mobile Cash Systems purportedly sold KS and DS two "wireless terminal machines." However, as discussed below, the Hearing Panel determined that the investments were securities within the meaning of the federal securities laws.

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[3] Ex. C–1.

[4] *Id.*

[5] Ex. C–2, at 3.

[6] *Id.*

[7] DO Decl., Ex. C–3, at ¶¶ 1–3.

1. Customers LO and DO

LO and DO were an elderly, retired couple with limited income. LO was approximately 90 years old and suffering diminished mental capacity, and his wife was approximately 85 years old.[8] DO assumed control of their finances in 1996 due to her husband's infirmity although she had little investment experience.

According to DO's Declaration, in 1999, their income was limited to social security payments of $481 per month and investment income from a family trust (the "Trust") they had established in 1996 with Day's assistance. In April 1999, Day invested the Trust's assets totaling $137,912 in The Income Fund of America (the "Income Fund"), a mutual fund managed by The American Fund Group.[9] Account statements for this investment show that LO and DO withdrew $750 per month from the Income Fund, which was more than the fund earned.[10]

In October 1999, Day recommended that they withdraw $70,000 of the Trust's investment in the Income Fund and invest the proceeds in World Cash.[11] According to DO, Day promised her that their investment in World Cash would earn $750 per month or $9,000 per year.[12] In making this recommendation, Day did not provide DO with any financial information or promotional materials about World Cash, nor did he tell them that he would receive a 15% commission on the transaction.[13]

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[8] *Id.* at ¶ 1; Maniwa Decl. ¶ 7.

[9] Ex. C–6.

[10] *Id.*

[11] Ex. C–7; DO Decl., Ex. C–3, at ¶¶ 1–4.

[12] DO Decl., Ex. C–3, at ¶ 3.

[13] *Id.* at ¶ 6.

In reliance on Day's recommendation, LO and DO invested in World Cash. Day processed a request to redeem $70,000 from the Income Fund and have the proceeds check issued directly to World Cash.[14] Day also had LO and DO sign the documents evidencing their investment. World Cash paid Day a $9,100 commission.[15]

LO and DO's investment was evidenced by four documents: (1) an Equipment Sales Agreement dated October 1, 1999;[16] (2) a Memorandum of Understanding dated October 1, 1999;[17] (3) a Services Agreement dated October 1, 1999;[18] and (4) a Bill of Sale dated October 26, 1999.[19] On their face, these documents evidence the sale of 20 cash ticket machines to LO and DO and provide for their placement and maintenance by World Cash. The Memorandum of Understanding and the Equipment Sales Agreement disclaim that the investment is a security and purport to confirm LO and DO's understanding that they were purchasing the machines as a "business opportunity."[20] The Services Agreement also contained a disclaimer that the "relationship with [World Cash] does not constitute the purchase of a security."[21] Despite these assurances, LO or DO added handwritten notes to the top of Exhibit A to the Services Agreement that read: "Please Start Monthly Interest Payments Immediately."[22] Notably, the Services Agreement

[14] Ex. C–7 and C–8.

[15] Ex. C–14, at 4.

[16] Ex. C–9, at 5.

[17] *Id.* at 3.

[18] Ex. C–10, at 3.

[19] Ex. C–9, at 1.

[20] Ex. C–9, at 4.

[21] Ex. C–10, at 14.

[22] *Id.* at 15, 16.

states that Exhibit A contained a schedule of the subject cash ticket machines, but it did not provide any identifying information. Indeed, none of the documents—including the Bill of Sale—identifies the machines World Cash purportedly sold to LO and DO.

LO and DO received four or five monthly checks of $750 each from World Cash, but have received no further return on their investment since then.[23] The last payment of any type they received from World Cash was in early 2000.[24]

2. Customers KS and DS

KS and DS also were an elderly, retired couple. Their income was approximately $26,300 per year, and they had total liquid assets (excluding the value of their home) of approximately $37,000.[25] KS was approximately 92 years old, and his wife was approximately 80 years old.[26] They had no investment experience.[27]

Day first contacted KS and DS about updating their living trust and later suggested that they take the proceeds from a maturing certificate of deposit (approximately $10,500) and invest it in the Income Fund of America, the same mutual fund Day had recommended to LO and DO.[28] DS, however, was not satisfied with the Income Fund, and Day then recommended that they invest in Mobile Cash Systems.[29] KS and DS accepted Day's

[23] DO Decl., Ex. C–3, at ¶ 5.

[24] *Id.*

[25] Ex. C–11, at 3.

[26] Ex. C–23, at 1.

[27] Ex. C–11, at 2.

[28] Maniwa Decl. ¶ 21.

[29] Ex. C–11, at 7.

recommendation and authorized him to reinvest the funds in the Income Fund in Mobile Cash Systems.[30]

On January 14, 2000, Day withdrew $9,000 from KS and DS's mutual fund account. However, the proceeds were not enough for the investment in Mobile Cash Systems. Day therefore added $500 to make up the shortfall.[31] Day received a $2,000 commission on the transaction.[32]

According to KS and DS, they invested in Mobile Cash Systems because Day told them it was a good-sounding company with a promising future. Day provided them no information about its financial condition, operating history, management, or assets.[33]

The documents evidencing KS and DS's investment in Mobile Cash Systems are substantially equivalent to those evidencing LO and DO's investment in World Cash. They are: (1) an Equipment Sales Agreement dated February 7, 2000;[34] (2) a Memorandum of Understanding dated February 7, 2000;[35] (3) and a services agreement with World Wireless Solutions, Inc. (also known as Wireless Express USA, Inc.).[36] The record is unclear regarding the connection between Mobile Cash Systems and the service provider.

Under the terms of the Equipment Sales Agreement, KS and DS purchased two mobile terminals, which they were to locate and operate. The Memorandum of

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[30] Maniwa Decl. ¶ 22.

[31] *Id.*

[32] Ex. C–14, at 4.

[33] Maniwa Decl. ¶ 23.

[34] Ex. C–23, at 6.

[35] *Id.* at 9.

[36] *Id.* at 19 (Letter confirming service agreement for transaction monitoring, maintenance, and management.)

Understanding and the Equipment Sales Agreement disclaim that their investment is a security and purport to confirm KS and DS's understanding that they were purchasing the machines to run a "wireless terminal machine business."[37] However, none of the associated documents provided to KS and DS identify the subject wireless terminal machines covered by the Equipment Sales Agreement.[38]

At first KS and DS received a monthly check from Mobile Cash Systems in the amount of $108.34. They received seven equal payments. Then, by letter dated April 4, 2001,[39] they were notified that all payments would cease; they have not received any further payments or the return of their investment.

3. The Investments Are Securities

Section 2(a)(1) of the Securities Act of 1933 defines "security" to include an "investment contract." In *SEC v. W.J. Howey Co.*,[40] the seminal opinion on the meaning of "investment contract" under the federal securities laws, the Supreme Court held that an "investment contract" is (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit to be derived solely from the efforts of the promoter or a third party.[41] "The substance of an investment contract is a security-like interest in a 'common enterprise' that is expected to generate profits through the efforts of others."[42]

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[37] Ex. C–23, at 9, ¶¶ 2, 3.

[38] *See* Ex. C–23, at 11 ("Exhibit A, Site and Service Election Form").

[39] Ex. C–23, at 18.

[40] 328 U.S. 293 (1946).

[41] *Id.* at 298.

[42] *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

Applying the three-part *Howey* test to the facts and circumstances of this case, the Hearing Panel determines that the documents underlying the investments in World Cash and Mobile Cash Systems constitute investment contracts within the meaning of Section 2(a)(1) of the Securities Act of 1933. The investors were elderly people seeking secure investments to supplement their retirement income. They lacked the financial resources, knowledge, and skill to operate the machines they purchased. Accordingly, they were entirely dependent on the seller to manage their investments. The investors were attracted to the investments based on Day's recommendations that the investments were safe and appropriate. Each couple expected to receive a set monthly return, which they did until the investments failed completely. LO and DO received $750 per month, the precise amount they told Day they needed. And KS and DS received equal monthly payments of $108.34. The lack of fluctuation in payments demonstrates that the investors were not receiving net business profits; rather, they were receiving a fixed return on their investments. The "profits" the investors received were in proportion to the amount they invested. In short, their investments had many of the characteristics of a security and none of the characteristics of a business venture.

Moreover, the Hearing Panel finds that the "common enterprise" requirement of *Howey* is met by "strict vertical commonality," one of three forms of commonality courts variously have recognized to meet this requirement. Strict vertical commonality requires that the investors' fortunes be "interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[43] Here, the investors' "profits"

[43] *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

were tied to the continuing success of World Cash, Mobile Cash Systems, and their service providers. When these firms failed, the investors lost everything, including the machines they purportedly purchased.

The Hearing Panel has applied the strict vertical commonality formulation of the common enterprise standard under *Howey* although the courts have not settled on one approach, and the National Adjudicatory Council ("NAC") has applied only the horizontal commonality standard to date,[44] which requires "the pooling of assets from multiple investors so that all share in the profits and risks of the enterprise."[45] In contrast, "broad vertical commonality" requires that "the well-being of all investors be dependent upon the promoter's expertise."[46] The Hearing Panel applied strict vertical commonality because, as the Securities and Exchange Commission has stated, the strict vertical commonality standard "better serves the remedial purposes of the securities laws than to require 'horizontal commonality' in all cases."[47]

4. Violation of NASD Conduct Rule 2310(a)

NASD Conduct Rule 2310(a) provides that, in recommending to a customer the purchase of a security, a representative must have "'reasonable grounds for believing that the recommendation is suitable for such customer based on the customer's other security

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[44] *See, e.g.*, *District Bus. Conduct Comm. v. Kunz*, No. C3A960029, 1999 NASD Discip. LEXIS 20, at *21 (N.A.C. July 7, 1999), *aff'd*, *Kevin D. Kunz*, Exchange Act Release No. 45290, 2002 SEC LEXIS 104 (Jan. 16, 2002).

[45] *Id.*

[46] *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001) (citation omitted).

[47] *Joseph F. Reese*, Initial Dec. Release No. 142, 1999 SEC LEXIS 917, at *18–19 (May 6, 1999) (citing Louis Loss & Joel Seligman, Securities Regulation ¶ 3A.1.d.(i)(2) (3d ed. 1989)). *But cf. Department of Enforcement v. Meckler*, No. C01020003, (O.H.O. Sept. 24, 2002) < http://www.nasdr.com/pdf-text/oho_dec02_17.pdf> (noting uncertainty over whether the NAC would adopt either form of vertical

holdings and financial situation and needs."[48] The rule is violated if there is a showing that a member lacked reasonable grounds for believing that its recommendation of a particular security was suitable for customers or it failed to obtain information concerning the suitability of a recommendation before executing the transaction.[49] Furthermore, "Conduct Rule 2310 provides that a representative may make only such recommendations as would be consistent with a customer's financial situation and needs."[50]

The Hearing Panel finds that Day made unsuitable recommendations to LO, DO, KS, and DS when he recommended—without a reasonable basis—the purchase of the World Cash and Mobile Cash Systems investment contracts. These investments were speculative and inappropriate for these investors who wanted to supplement their retirement income. Day knew of their limited resources as he had counseled them in the preparation of their family trusts, yet he nevertheless recommended these unsuitable investments, in violation of Conduct Rules 2110[51] and 2310(a).

C. Failure to Respond to Requests for Information

In the course of its investigation into the suitability of the investments Day sold, NASD Staff sent Day a written request for information about certain customers.[52] On January 14, 2002, Day responded, stating that his customers had instructed him not to

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commonality and finding insufficient evidence to conclude that an investment in Mobile Cash Systems was an investment contract).

[48] *District Bus. Conduct Comm. v. McNabb*, No. C01970021, 1999 WL 515761, at *13 (N.A.C. Mar. 31, 1999).

[49] *See District Bus. Conduct Comm. v. Moore*, No. C01970001, 1999 WL 1022136, at *4 (N.A.C. Aug. 9, 1999).

[50] *Kunz*, 1999 NASD Discip. LEXIS 20, at *62.

[51] A violation of another NASD rule or regulation constitutes a violation of Conduct Rule 2110. *See Steven J. Gluckman*, Exchange Act Release No. 41628, 1999 SEC LEXIS 1395, at *22 (July 20, 1999) (citations omitted).

release any information about them or their accounts.[53] Thus, Day refused to provide the requested information. LO, DO, KS, and DS were among the listed customers.

Since the staff's first request did not state that it was issued pursuant to NASD Procedural Rule 8210, on January 18, 2002, the staff sent Day two additional requests that specifically referenced Rule 8210.[54] The first request repeated the staff's earlier request for information about Day's customers, and the second request sought any written information supporting Day's claim that his customers had instructed him not to cooperate with NASD's investigation. Day responded, stating that his customers had given him oral instructions not to reveal any of their information, and therefore he would not provide any further information regarding those customers.[55]

NASD Staff then contacted LO, DO, KS, and DS to inquire about Day's claims that they had instructed him not to reveal any information to NASD. Each of them denied giving Day such instructions.[56] To the contrary, the customers told the staff that Day had contacted them on January 15, 2002, the day after his first response to NASD, asking them to send a letter instructing him to withhold their personal and financial information from NASD.[57]

NASD Procedural Rule 8210 provides that NASD Staff "shall have the right to … require a … person subject to [NASD's] jurisdiction to provide information orally … with respect to any matter involved in [an] investigation …." The rule further provides, "No

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[52] Ex. C–14.

[53] Ex. C–15.

[54] Maniwa Decl. ¶¶ 28, 30; Ex. C–16 and Ex. C–17.

[55] Ex. C–18.

[56] Maniwa Decl. ¶¶ 33–34.

member or person shall fail to provide information or testimony … pursuant to this Rule." The NAC recently reiterated the "well established [principle] that because NASD lacks subpoena power over its members, a failure to provide information fully and promptly undermines NASD's ability to carry out its regulatory mandate."[58]

Here, the evidence is clear that Day not only refused to comply with the staff's requests for information, but he tried to obstruct NASD's investigation. He falsely reported that his customers had instructed him not to cooperate and then attempted to get them to send a letter to that effect. By refusing to answer, Day impeded NASD Staff's ability to pursue the investigation into the suitability of the investments he was recommending to his customers, and he thereby undermined NASD's ability to carry out its regulatory mandate. Accordingly, the Hearing Panel finds that Day violated NASD Procedural Rule 8210 and NASD Conduct Rule 2110.

IV. SANCTIONS

The NASD Sanction Guidelines suggest that an individual be barred and fined in an amount between $25,000 and $50,000 for not responding in any manner to a properly noticed request for information unless mitigating circumstances exist that warrant a lesser sanction.[59] Here, the record does not demonstrate the existence of any such mitigating factors. Thus, in accordance with the Department's request, the Hearing Panel will bar Day for his failure to respond to the Rule 8210 requests for information. In addition, the

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[57] Ex. C–21; Ex. C–22.

[58] *Department of Enforcement v. Valentino,* No. FPI010004, 2003 NASD Discip. LEXIS 15, at *12 (N.A.C. May 21, 2003).

[59] NASD Sanction Guidelines 39 (2001 ed.).

Hearing Panel will fine Day $50,000, which fine shall be due and payable if and when he re-enters the securities industry.

The Department also requests that Day be barred and ordered to pay restitution for making unsuitable recommendations in violation of NASD Conduct Rule 2310(a). The Guidelines recommend a fine of $2,500 to $75,000 and a suspension for a period of 10 business days to a year.[60] In egregious cases, the Guidelines suggest a longer suspension of up to two years or a bar.[61]

The Hearing Panel finds that Day's unsuitable recommendations were egregious. Day violated the trust of his elderly customers. He misrepresented the nature of the risky investments he recommended, resulting in the loss of their entire investments. The Hearing Panel also took into consideration Day's attempt to frustrate NASD's investigation of these transactions as an aggravating factor. Accordingly, the Hearing Panel determines that a bar and a fine of $75,000 also is warranted for this violation. The fine shall be due and payable if and when Day re-enters the securities industry. In addition, the Hearing Panel finds that Day should be ordered to pay restitution to his customers.

V. ORDER

Respondent Douglas Conant Day is barred from associating with any NASD member firm in any capacity and fined $50,000 for failing to respond to the Rule 8210 requests for information, in violation of NASD Procedural Rule 8210 and NASD Conduct Rule 2110. Day is barred from associating with any NASD member firm in any capacity

[60] *Id.* at 99.

[61] *Id.*

and fined $75,000 for making unsuitable recommendations, in violation of NASD Conduct Rules 2110 and 2310(a).

In addition, Day is ordered to pay restitution in the amount of $70,000 to LO and DO, plus interest thereon from October 1, 1999, until paid; and in the amount of $9,500 to KS and DS, plus interest thereon from January 14, 2000, until paid. Interest shall be calculated at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2).

These sanctions shall become effective on a date set by NASD, but not sooner than 30 days after this decision becomes the final disciplinary action of NASD, except: (1) if this decision becomes NASD's final disciplinary action, the bars shall become effective immediately; and (2) the foregoing fines shall be due and payable if and when Day re-enters the securities industry.[62]

Andrew H. Perkins
Hearing Officer
For the Hearing Panel

Copies to:

Douglas Conant Day (by FedEx, next day delivery, and first-class mail)
David A. Watson, Esq. (by first-class and electronic mail)
Rory C. Flynn, Esq. (by first-class and electronic mail)

[62] The Hearing Panel has considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.