NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	Disciplinary Proceeding
	:	No. C01010018
Complainant,	:	
	:	
v.	:	Hearing Officer – DMF
	:	
BRENDAN CONLEY WALSH	:	
(CRD# 2228232)	:	**HEARING PANEL DECISION**
Greenbrae, CA	:	
	:	
	:	October 7, 2002
Respondent.	:	

Respondent is suspended in all capacities for 90 days and fined $56,000 for participating in private securities transactions for compensation without giving prior written notice to and obtaining prior written permission from the NASD member firms with which he was associated, in violation of Rules 3040 and 2110.

Appearances

David A. Watson, Esq., Regional Counsel, San Francisco, CA (Rory C. Flynn, Washington, DC, Of Counsel) for Department of Enforcement.

Alvin L. Fishman, Esq., San Francisco, CA, for respondent.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on December 27, 2001, against respondent Brendan Conley Walsh charging that he violated NASD Rules 3040 and 2110 by participating in private securities transactions for compensation without providing prior written notification to and obtaining prior written permission from the NASD members with which Walsh was associated. Walsh filed an Answer denying the charge and requested a hearing, which was held in San Francisco, CA, on August 14, 2002,

before a Hearing Panel that included a Hearing Officer and two members of the District 1 Committee. The parties also filed post-hearing submissions.[1]

II. Facts

Walsh is an insurance agent with Northwestern Mutual Life Insurance Company. He is also registered as a Series 6 Investment Company and Variable Contracts Products Limited Representative. At the relevant time, he was registered through two NASD members affiliated with Northwestern Mutual Life Insurance: Northwestern Mutual Investment Services, LLC ("NMIS"), through which Northwestern Mutual agents sold variable life insurance and annuities, and Robert W. Baird & Co., Inc., through which they sold mutual funds. Subsequent to the events giving rise to this proceeding, Northwestern Mutual changed this arrangement, so that now Walsh and other Northwestern Mutual agents are registered only through NMIS. (Stip. ¶¶ 2-3; JX 1; Tr. 18, 70.)

In early 2000, Walsh and a partner founded Husbands.com, Inc. (also known as Husbands Interactive Media, Inc.) through which they planned to operate an Internet web site with content aimed at "the 25-54 married male market." Walsh was Chief Executive Officer of the company and his co-owner was Vice-President of Marketing. They raised start-up funds for the company from investors, primarily friends and family of the principals. (Stip. ¶¶ 6-9, 11; JX 10.)

From May 11, 2000 through October 3, 2000, Husbands.com issued notes totaling $940,000 to 12 investors. The largest investor was TS, father of Walsh's Husbands.com partner, who invested $500,000. Other investors included Walsh's father, his father's

[1] The hearing transcript is cited "Tr.," the parties' joint exhibits as "JX," Enforcement's exhibit as "CX," Respondent's exhibits as "RX," and Stipulations between Enforcement and Walsh as "Stip."

business partner, and various personal and family acquaintances. Apart from TS, only two of the investors were not family or long time friends of Walsh – an accountant who was a friend of his father's business partner, and the owner of a firm that made "investments into small firms like ours." Walsh participated in soliciting all these investments. (Stip. 10; Tr. 28-31, 46-51.)

Husbands.com issued each investor a "Convertible Promissory Note." The notes provided that the outstanding principal balance would automatically convert into shares of preferred stock of Husbands.com if the company issued preferred stock by October 1, 2000. If the company did not issue preferred stock by that date, the entire outstanding principal balance and unpaid accrued interest would become due and payable. According to Walsh, however, his intention was to obtain venture capital funding for the company and convert the notes to preferred stock; "[t]here was never a discussion about calling a note or the notes maturing." (JX 3-9; Tr. 62, 115-16; Stip. ¶¶ 10-16.)

Walsh devoted considerable effort to the Husbands.com business. Although he continued to work for Northwestern Mutual, he spent eight to twelve hours a day on Husbands.com, primarily looking for longer-term funding. From May through September 2000, he drew a total of $50,000 in salary from the firm for his efforts. He continued raising funds from friends and family through at least October 3, 2000. Walsh testified that by some time in October, he determined that Husbands.com would be unable to obtain venture capital funding and decided to wind up the business. (Tr. 38, 41, 56-57, 118-20, 123-25.)

Walsh did not give NMIS or Baird prior notice of his activities on behalf of Husbands.com, or obtain their prior approval. Indeed, on April 9, 2000, just one day

before Husbands.com was incorporated, he completed an Outside Business Activities Disclosure Questionnaire for NMIS in which he answered "no" to a series of questions asking whether he was or had been involved in any outside business. (Stip. ¶¶ 6-13; CX 1; Tr. 53-54.)

In August or September 2000 – the precise date is not entirely clear from the record – Walsh listened to a compliance audiotape NMIS had sent to all of its registered representatives warning about the need to disclose Internet-related business activities. Apparently the tape specifically referred to the use of notes to fund Internet start-ups and warned that they might be considered securities. Walsh testified that upon listening to the tape he became concerned and immediately contacted the NMIS compliance officer in his local office, disclosing his activities in connection with Husbands.com. (Tr. 34-37; Stip. 18-19.)

The local compliance officer testified that after Walsh approached him, he consulted with local management, as well as NMIS's central compliance department, which asked for additional information. Walsh cooperated fully in the investigation. On October 5, 2000, NMIS sent Walsh a letter notifying him that NMIS and Baird disapproved of his involvement in Husbands.com, and required that he not solicit additional investors or engage in other activities on behalf of Husbands.com. The letter advised Walsh that his NMIS registration was "inactive" as of October 5; that he could not engage in the solicitation or sale of variable products or other securities; and that NMIS would be requesting additional information from him. Baird also suspended Walsh, effective October 9, 2000. (Tr. 36-37, 78-81, 91-95, 99; RX 1, 13; Stip. ¶ 20.)

On October 25, 2000, NMIS sent Walsh another letter advising him that it had "determined that it is not possible for you to remain a registered representative of NMIS and continue your involvement with [H]usbands.com." The letter indicated NMIS's understanding that Walsh had decided to end his involvement with Husbands.com; stated that Walsh would have to complete that process by December 15, 2000; and advised Walsh that his suspension would continue "until you have completed the sale of [H]usbands.com." (RX 2.)

Walsh testified that he stopped all fund raising for Husbands.com as soon as he received the October 5 letter from NMIS. He also testified that, coincidentally, it was during October that he concluded that Husbands.com would not be able to obtain longer-term venture capital funding. He and his partner proceeded to dissolve the company, paying off the company's creditors and returning to the investors the company's remaining funds (approximately $17,000) by December 2000. (Tr. 37-39; 68, 118-20.)

While he wrapped up Husbands.com, Walsh was suspended by NMIS from October 5 to December 12, 2000. In addition, NMIS issued him a letter of reprimand, required that he take retraining at NMIS's home office, imposed special supervision over him for one year, and fined him $4,000. Baird also suspended him from October 9, 2000 to January 29, 2001. Witnesses from NMIS testified that Walsh had fully complied with all of the disciplinary sanctions imposed on him, and that the firm still wants to keep him as an associated person, even if NASD imposes additional sanctions in this proceeding. (RX 5, 13; Tr. 39-41, 70, 81-84, 96-97, 153; Stip. ¶22.)

III. Discussion

A. Violation

Rule 3040 prohibits any person associated with a member firm from "participat[ing] in any manner in a private securities transaction," unless, prior to participating in the transaction, the associated person provides "written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction …." A private securities transaction is "any securities transaction outside the regular course or scope of an associated person's employment with a member …." If the associated person has received or may receive selling compensation for the transaction, the firm must approve or disapprove the person's participation, in writing, and if the firm approves, it must record the transaction on the firm's books and records and supervise the associated person's participation "as if the transaction were executed on behalf of the member."

The SEC has explained the purpose of the rule:

> The regulatory scheme under the Exchange Act, in which the NASD is assigned a vital role, imposes on broker/dealer entities and NASD member firms the responsibility to exercise appropriate supervision over their personnel for the protection of investors. Where employees effect transactions for customers outside of the normal channels and without disclosure to the employer, the public is deprived of protection which it is entitled to expect. Moreover, the employer may also thus be exposed to risks to which it should not be exposed. Thus, such conduct is not only potentially harmful to public investors, but inconsistent with the obligation of an employee to serve his employer faithfully . . . . There is always a possibility in these situations that some improper conduct may be involved or that the employer's interests may be adversely affected. At the least, the employer should be enabled to make that determination.

Anthony J. Amato, 45 S.E.C. 282, 285 (1973) (footnotes omitted).

In his post-hearing submission, Walsh contends that Rule 3040 does not apply because the Husbands.com notes were not securities. Section 3(a)(10) of the Securities Exchange Act defines the term "security" as including "any note." In spite of this, it is well established that not every note is a security. In Reves v. Ernst & Young, 494 U.S. 56, 61-63 (1990), the Supreme Court explained that Congress intended to protect investors by adopting "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment," but the Court recognized that "notes … are used in a variety of settings, not all of which involve investments."

To distinguish "notes issued in an investment context (which are 'securities') from notes issued in a commercial or consumer context (which are not)" (id. at 63), the Reves Court established a "family resemblance" test, under which every note is presumed to be a security unless it bears a strong resemblance to certain financial instruments used in commercial or consumer transactions: "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business," as well as "notes evidencing loans by commercial banks for current operations." Id. at 65, quoting Exchange Nat. Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976), and Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir. 1984).

Whether a note resembles these instruments, or should be added to the list, and therefore should be considered not to be a security, is determined by applying a four-part test that considers: (1) the motivations that would prompt a reasonable seller and buyer

to enter into the transaction; (2) the plan of distribution of the instrument; (3) whether the investing public would reasonably expect the instrument to be considered a security; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering the application of the securities acts unnecessary. Reves at 66-67. Once again, the purpose of this exercise is to distinguish investment notes from commercial or consumer finance notes.

Walsh contends that application of the Reves test leads to the conclusion that the Husbands.com notes are not securities because they closely resemble notes evidencing a "character" loan to a bank customer. Citing McNabb v. SEC, 2002 U.S. App. LEXIS 16158 at *9 (9th Cir. Aug. 12, 2002), he points out that this category includes any note made to "cement or maintain an ongoing commercial relationship with the borrower." The Hearing Panel disagrees. Applying the Reves test leads to precisely the opposite conclusion – the Husbands.com notes are plainly "securities."

First, the notes were issued to individual investors in exchange for seed money for the general start-up operations of a new business; they did not arise out of or reflect a commercial relationship between the parties. The notes promised investors a return on their investments and equity ownership interests in Husbands.com, through preferred stock, if the company succeeded in obtaining longer-term funding. "If the seller's purpose is to raise money for the general use of a business enterprise … and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'" Reves at 66.

Second, the notes were distributed to 12 individual investors. As the SEC explained in analogous circumstances:

> The fact that the public offering was not large and that there is no proof of secondary trading in the notes is not determinative. Common trading is indicated here because the note sales were targeted to individual retail customers. In determining whether there has been a public distribution, "the focus of the inquiry should be on the need of the offerees for the protections afforded by the federal securities laws." Here, twelve largely inexperienced investors bought these notes. We previously have found that sales of as few as five notes to members of the public can constitute a sale of securities.

John P. Goldsworthy, Exch. Act. Rel. No. 45926, 2002 SEC LEXIS 1279, at *22-23 (May 15, 2002) (citations and footnotes omitted). The fact that some, but not all, of the investors were previously acquainted with Walsh is irrelevant. "The existence of a social relationship does not mean, however, that such an investor would not be entitled to the same protections that a stranger to the offeror would receive in an offering under the federal securities laws." Gerald James Stoiber, 53 S.E.C. 171, 179 (1997), aff'd, 161 F.3d 745 (D.C. Cir. 1998).

Third, the notes expressly acknowledged that they were securities. At the top of each note, the following legend appears, in all capital letters (emphasis added):

> THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OR ANY STATE SECURITIES LAWS. SUCH SECURITIES MAY NOT BE SOLD OR TRANSFERRED IN THE ABSENCE OF SUCH REGISTRATION OR EXEMPTION THEREFROM UNDER SAID SECURITIES [sic] AND ANY APPLICABLE STATE SECURITIES LAWS.

From these statements, investors would reasonably have understood that the notes were securities.

Fourth, Walsh has pointed to no risk-reducing factor, such as the existence of some other regulatory scheme, that would eliminate the need for application of the securities laws to protect investors in these notes. In short, the Panel finds that the Reves test leads inescapably to the conclusion that the notes were securities.

Walsh also relies on a portion of Section 3(a)(10) of the Exchange Act that excludes from the definition of security "any note … which has a maturity at the time of issuance of not exceeding nine months…." Walsh points out that the Husbands.com notes were due to be paid or converted to preferred stock by October 1, 2000, which was less than nine months from the date they were issued.

Once again, the statutory language has not been applied literally. "The mere fact that a note has a maturity of less than nine months does not take the case out of [the securities laws], unless the note fits the general notion of 'commercial paper.'" Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795, 800 (2d Cir.), cert. denied, 414 U.S. (1973). More specifically, the exclusion applies only to short-term notes that are "(1) prime quality negotiable commercial paper, and (2) of a type not ordinarily purchased by the general public." Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075, 1079 (7th Cir. 1972), cert. denied, 409 U.S. 1009 (1972). The Husbands.com notes did not meet this description.

Furthermore, these notes did not have a "maturity" of less than nine months when issued. Walsh admitted that in issuing the notes, he focused on the plan to convert them to preferred stock. "From my discussions [with the attorney who drafted the notes], six months was the normal convertibility period. There was no real discussion about the deadline." He testified that investors did not expect to have their funds returned by the October 1 deadline, but rather expected to become preferred shareholders of the company. "There was never a discussion about calling a note or the notes maturing." (Tr. 60, 62, 115-16.)

Thus, the notes did not reflect short-term loans to Husbands.com, but rather the initial step in a plan to effect permanent equity investments in the company. The notes became due only because Husbands.com failed to obtain the longer-term funding it needed in order to issue the planned preferred stock. Under these circumstances, as a practical matter the investments had an indefinite term when issued; therefore, the nine-month maturity exception was inapplicable. See Reves at 72-73 (holding that because demand notes have an indefinite term when issued, and therefore may or may not become due within nine months, the exclusion does not apply).

The Hearing Panel thus finds that the notes were securities, and that Rule 3040 applied. Under that Rule, Walsh was required to give advance written notice to NMIS and Baird, and, because he received selling compensation, in the form of his Husbands.com salary, he was required to obtain their approval to participate in the sale of the notes.[2] He admits he did not give the required notice, or receive the required approval. Therefore, the Panel finds that Walsh violated Rule 3040, as charged. By violating that rule, he also violated Rule 2110.

B. Sanctions

For violations of Rule 3040, the Sanction Guidelines recommend that a respondent be fined $5,000 to $50,000, plus the amount of any financial benefit the respondent earned, and suspended for up to one year. In egregious cases, the Guidelines

[2] Rule 3040(e)(2) defines "selling compensation" very broadly to include "any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security." The $50,000 salary that Husbands.com paid Walsh, utilizing funds raised through issuance of the notes, constituted selling compensation. See Department of Enforcement v. Goritz, No. C10000037, 2002 NASD Discip. LEXIS 7, at *7, n.6 (NAC Apr. 26, 2002); Department of Enforcement v. Newcomb, No. C3A990050, 2000 NASD Discip. LEXIS 15, at *22 (Nov. 16, 2000), aff'd, Exchange Act Rel. No. 44945, 2001 SEC LEXIS 2172 (Oct. 18, 2001).

suggest a longer suspension of up to two years, or a bar. NASD Sanction Guidelines at 19 (2001 ed.)

Enforcement recommended that the Hearing Panel fine Walsh a total of $55,000, including a base fine of $5,000 plus the $50,000 salary that Husbands.com paid him, and suspend him for one year in all capacities. Enforcement recommended, however, that the Hearing Panel give Walsh credit against these sanctions for the time he was suspended by NMIS and Baird, and for the fine that NMIS imposed. In addition, Enforcement suggested it might be appropriate to allow Walsh to obtain a credit against the fine by paying all or some portion of the $50,000 to the investors, other than members of Walsh's family. In contrast, Walsh urged the Panel not to impose any additional suspension or fine beyond those already imposed by NMIS and Baird, but also urged that he be allowed to obtain a credit against any fine the Panel might impose by making payment to investors, although he would not exclude payments to his family members.

Enforcement arrived at its recommended sanctions by comparing the number of investors and the total amount invested in this case with the corresponding figures in Department of Enforcement v. Roger A. Hanson, No. C8A000059, 2002 NASD Discip. LEXIS 5, at *12 (NAC March 28, 2002). In that case, the National Adjudicatory Council imposed a six month suspension and a fine of $5,000, plus the amount of commissions the respondent earned on the sales. Enforcement recommended a longer suspension here because, while the number of investors was about the same, Walsh raised more money. (Tr. 168-69.)

The Hearing Panel was not persuaded by Enforcement's approach. As the NAC explained in Roger A. Hanson, "appropriate sanctions depend on the facts and

circumstances of each particular case and cannot be determined precisely by broad comparison with actions taken in other proceedings …." The facts of this case are quite different from those in Roger A. Hanson, and the appropriate sanctions turn on the Hearing Panel's assessment of all the relevant circumstances.

In arriving at appropriate sanctions for this case, the Hearing Panel looked first to the specific considerations listed in the Sanction Guidelines for violations of Rule 3040. NASD Sanction Guidelines, at 19. As aggravating factors, the Panel noted that Walsh had a proprietary interest in the selling enterprise, and that he not only failed to give NMIS and Baird oral notice, but affirmatively denied he was engaged in outside business activities when he completed his Outside Business Activities Disclosure Questionnaire.

On the other hand, Walsh unquestionably disclosed his interest in Husbands.com to the investors. And except for his father, his father's partner and one of his friends, all of whom owned some mutual funds through Baird, the investors were not customers of NMIS or Baird. Further, there was no evidence that Walsh used Northwestern Mutual's, NMIS's or Baird's premises, facilities, name or goodwill to facilitate these transactions. On the contrary, Walsh testified that he "was very clear [to the investors] that this had nothing to do with Northwestern Mutual [nor] was it backed by them in any way," and most of the investors provided "Declarations of Support" stating, among other things, that they "understood that this was not related to [Walsh's] employment with Northwestern Mutual Life Insurance Company." (Tr. 29; RX 11A-I.) Thus, application of the specific considerations for Rule 3040 violations leads the Panel to conclude that Walsh's misconduct was serious, but not egregious.

The Panel also consulted the general considerations listed in the Guidelines that are applicable to all violations. NASD Sanction Guidelines at 9-10. In that regard, the Panel gave substantial weight to Walsh's voluntary disclosure of his Husbands.com involvement to NMIS and Baird before the firms or NASD detected it. Enforcement pointed out that this is an unusual circumstance and urged the Panel to consider it as a significant mitigating factor.

Taking all these circumstances into consideration, the Hearing Panel concluded that appropriate sanctions in this case would be a 180 day suspension, somewhat shorter than that recommended by Enforcement, together with a base fine of $10,000, somewhat more than Enforcement recommended, plus $50,000, representing Walsh's gain from his misconduct, for a total of $60,000. The Panel agreed with Enforcement, however, that, in accordance with the Guidelines, Walsh should receive credit for the disciplinary sanctions imposed on Walsh by NMIS and Baird. More specifically, the Panel will give Walsh 90 days credit toward the suspension and $4,000 credit toward the fine. Thus, the Panel will suspend Walsh for 90 days and fine him $56,000.

The Hearing Panel also considered but rejected the parties' suggestion that Walsh be allowed to obtain a credit of up to $50,000 against his fine by making payments to the investors. In Roger A. Hanson the NAC directed that "adjudicators should start with the approach of the Guidelines, which instruct that a respondent should pay a fine to the NASD that includes a respondent's commissions or other financial benefits." Although in some cases it may be appropriate to allow a respondent to obtain a credit against a fine by making payments to injured customers, here the payments would be in the nature of a windfall to the investors. The investors intended to provide seed money to fund

Husbands.com's start-up operations, and it appears from the record that their funds were used as they intended. None have complained; most submitted declarations in support of Walsh. Under these circumstances, the Panel finds that all the money should be paid to NASD, in order to further the disgorgement goal of deterring misconduct by "prevent[ing] the wrongdoer from enriching himself by his wrongs." SEC v. Hughes Capital Corp., 917 F. Supp. 1080, 1085 (D.N.J. 1996).

V. Conclusion

For violating NASD Rules 3040 and 2110 by participating in private securities transactions for compensation without giving the required written notice to and obtaining written permission from the NASD members with which he was associated, respondent Brendan Conley Walsh is suspended from association with any member in any capacity for 90 days and fined $56,000. In addition, Walsh shall pay costs in the amount of $1,139.90, including an administrative fee of $750 and hearing transcript costs of $389.90.

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 that, if this decision becomes NASD's final disciplinary action, Walsh's suspension shall become effective with the opening of business on Monday December 2, 2002 and end on March 2, 2003.[3]

HEARING PANEL

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By: David M. FitzGerald
Hearing Officer

[3] 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.

Copies to:

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