NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. ANTHONY H. BARKATE (CRD #1255255) Bakersfield, CA, Respondent.	Disciplinary Proceeding No. C02010041 **HEARING PANEL DECISION** Hearing Officer - SW Dated: September 5, 2002

For violating NASD Conduct Rules 3040 and 2110 by participating in the offer and sale of securities without prior written notice to, and approval of, his employer, the Hearing Panel barred Respondent and fined him $400,144 to be reduced by any amounts paid in disgorgement of commissions within one month of the date of this decision. The Hearing Panel also ordered Respondent to pay the $5,141.21 costs of the Hearing.

Appearances

David A. Greene, Esq., Regional Attorney, Los Angeles, California, for the Department of Enforcement.

Sheldon M. Jaffe, Esq., Los Angeles, California, for Respondent Anthony Barkate.

DECISION

I. Procedural Background

On August 9, 2001, NASD Department of Enforcement ("Enforcement") filed its Complaint in this disciplinary proceeding. The Complaint alleges that, while associated with Securities Service Network, Inc. ("Securities Network"), Respondent offered and sold securities issued by various TLC entities[1] ("TLC instruments"), without prior notice to Securities Network, in violation of Conduct Rules 3040 and 2110.[2]

Respondent admitted that he participated in the sale of the TLC instruments, without providing prior notice to, or obtaining prior approval from, Securities Network, and he stipulated that the TLC instruments were securities. Nevertheless, Respondent argued that his sanction should be minimal because (i) he reasonably believed that the TLC instruments were not securities when he sold them, and (ii) he submitted an outside business activity disclosure form with information concerning TLC to Securities Network in August 1998.

On April 9, 10, and 11, 2002, the Hearing Panel, composed of an NASD Hearing Officer and two current members of the District 2 Committee, held a Hearing on this matter in Los Angeles, California.[3] In addition to the testimony of Respondent, Enforcement offered the testimony of a Securities Network compliance employee, David Bellaire, and two former Securities Network compliance employees, Darla Goodrich and Jeffrey Currey. Respondent testified on his own behalf and offered the testimony of Respondent's two employees, Dianna Jones and Cassandra Woodward.

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[1] TLC entities include the following: TLC America, Inc., TLC Investments & Trade Co., Brea Development Company, TLC Brokerage, Inc., dba TLC Marketing, TLC Development, Inc., and TLC Real Properties RLLP-1.

[2] In the event that the TLC instruments were determined not to be securities, count two of the two-count Complaint alleged, in the alternative, that Respondent's participation in the TLC sales without providing prior notice to Securities Network violated Conduct Rules 3030 and 2110. Because Respondent stipulated and the Hearing Panel finds that the TLC instruments were securities, count two is dismissed.

[3] "Tr." refers to the transcript of the Hearing held on April 9, 10, and 11, 2002; "JX" refers to the Parties' joint exhibits; "CX" refers to Complainant's exhibits; and "RX" refers to Respondent's exhibits.

The Hearing Panel admitted: (i) 44 joint exhibits, labeled JX-1 through JX-4 and JX-6 through JX-45; (ii) four exhibits offered by Enforcement, labeled CX-1, CX-2, CX-4, and CX-5; and (iii) four exhibits offered by Respondent, labeled RX-1 through RX-3 and RX-5.[4] The Hearing Panel also admitted two joint stipulations, which the Parties submitted.[5] The Parties filed post-hearing briefs on May 17, 2002.

II. Findings of Fact and Conclusions of Law

A. Jurisdiction

In April 1984, Respondent became initially registered with NASD as a general securities representative. (Stip. at ¶1). In May 1991, Respondent passed his Series 24 principal exam. (JX-3, p. 14). From June 1997 to April 1999, Respondent was associated with Securities Network as a general securities principal and general securities representative. (Stip. at ¶1). Since May 2000, Respondent has been registered with California Financial Network, Inc. ("California Financial"). (Id.). Accordingly, the Hearing Panel determines that NASD has jurisdiction over Respondent.

B. Respondent Offered and Sold Securities Without Prior Written Notice to, and Approval of, Securities Network

Rule 3040 requires that an associated person who intends to participate in a private securities transaction, prior to the transaction, must "provide written notice to the

[4] The Parties withdrew joint exhibit JX-5, which contained an excerpt from Securities Network's Written Supervisory Procedures Manual that was maintained internally and not provided to Respondent. The Hearing Officer rejected, as not relevant, Respondent's exhibit RX-4, which contained warranty deeds for certain TLC customers that were forwarded to those customers after the investment was made and were similar to the warranty deeds contained in joint exhibit JX-27, pp. 21-22.

[5] Statements in the Pre-Hearing Stipulations, dated March 20, 2002, between Respondent and Enforcement are referred to as "Stip. at ¶." The two paragraphs in the second Stipulation between Respondent and Enforcement are referred to as "Stip. II at ¶."

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 . . . ." Further, if the transaction is for compensation, the member firm must approve or disapprove of the proposed transaction in writing.[6]

Rule 3040 defines a "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission."

1. Chronology

From June 1996 to the present, Respondent has owned and operated California Financial, located in Bakersfield, California.[7] (Stip. at ¶1). Prior to California Financial becoming an NASD member firm in May 2000, Respondent was associated with several other NASD member firms including Securities Network, a firm headquartered in Tennessee. (Id.)

On September 4, 1997, Respondent executed a registered representative agreement with Securities Network. (JX-4; Tr. p. 471). Among other things, the agreement provided that Respondent would operate his California Financial office as an office of supervisory jurisdiction for Securities Network. (JX-4, p. 1).

[6] Pursuant to Rule 3040, if the firm approves participation, "the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member."

[7] As of the Hearing, California Financial, including the home office, had three offices and 18 registered representatives. (Tr. p. 396). Respondent is registered as California Financial's general securities principal, general securities representative, municipal securities principal, and financial and operations principal. (JX-3, pp. 5-6).

On September 18, 1997, Respondent completed his first Securities Network outside business activity disclosure form. (JX-28). On the form, Respondent represented that he had listed all sources of outside income, and he would immediately notify Securities Network in writing of any additions or deletions. (Id.).

In March 1998, Respondent was introduced to the TLC instruments. (Tr. p. 479). In July 1998, Respondent completed his first three sales of TLC instruments for a total of $278,896, resulting in upfront commissions of $13,388 and deferred commissions of $3,693.[8] (Schedule A to Stip.). In total, from July 1998 through March 1999, while associated with Securities Network, Respondent solicited and sold $6.8 million in TLC instruments, in the amounts, on the dates, and to the individuals listed in Schedule A of the March 20, 2002 Stipulation.[9] (Stip. at ¶¶3-4). Respondent testified that his commissions ranged from 4% to 6% on the gross amount of each instrument. (Tr. p. 457). The TLC commissions totaled $400,144 and were made payable to Respondent.[10] (Stip. at ¶4; JX-33, pp. 101-120, 123-130).

In March 1999, Respondent sent to Securities Network for its approval a proposed website that advertised the sale of TLC instruments by California Financial. (Tr. p. 409; JX-14). Respondent testified that he submitted the proposed website because he believed that certain disclosures were required to be included on a website, saying, " I knew it had

[8] On August 13, 1998, Respondent executed and completed an agent agreement with TLC Marketing to market the TLC instruments. (JX-13, p. 4).

[9] Exhibit A to the Stipulation lists 104 transactions and 93 individual customers, not including Respondent, and 10 customers that purchased TLC instruments in two separate transactions.

[10] The first two checks were from Golden Age Consultants, a precursor to TLC Marketing. (JX-25, p. 1; JX-33, pp. 123-124).

to be 'securities offered through' and other disclosures, too."[11] (Tr. p. 410). The proposed website stated: "Are You Tired of Low CD Rates & Volatile Stock Prices? How does this sound? 10% to 12% 1 Year <u>Guaranteed</u> Tax Lien Certificates . . . If you want 'Safety with Higher Returns' then Tax Lien Certificates may be for you." (JX-9, p. 1).

Upon receipt of California Financial's proposed website, dated March 31, 1999, Securities Network immediately sent David Bellaire, a compliance employee, to Respondent's offices on April 1, 1999, to conduct a special audit. (JX-9; JX-10). On April 1, 1999, Respondent was directed to cease selling the TLC instruments. (Tr. p. 464). On April 12, 1999, Securities Network terminated Respondent's employment, and it terminated his registration on April 16, 1999. (JX-3, p. 8).

In October 2000, the SEC filed a complaint against the TLC entities alleging a Ponzi scheme.[12] (JX-30). On October 19, 2001, the District Court for the Central District of California entered a preliminary injunction against TLC and appointed a receiver for TLC.[13] (JX-31).

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[11] When soliciting securities covered by the Securities Network registered representative agreement, Respondent agreed to obtain written approval from Securities Network for solicitation material. (JX-4, p. 3).

[12] A Ponzi scheme is an arrangement whereby an enterprise makes payments to investors from the proceeds of later investments rather than from profits of the underlying business venture.

[13] The TLC receiver filed a lawsuit against Respondent, California Financial, and Respondent's spouse to recover the TLC commissions earned. (JX-33, pp. 1-29). The litigation was still pending at the time of the Hearing. (Tr. p. 466).

2. The TLC Instrument is a Security

a. TLC

TLC was an entity created to invest in tax lien certificates. (Stip. at ¶5; JX-32, p. 1). A tax lien certificate is the right to collect delinquent taxes on real property. (JX-23, p. 16). If a property owner fails to pay the delinquent property taxes, eventually, the municipality may foreclose on the property and sell a tax lien at auction. (Tr. p. 470). After the sale, the property owner has a certain amount of time to clear the property of the tax lien, by paying a penalty and the amount of the tax lien.[14] (Id.)

The TLC marketing materials described the investment process as follows: (1) the customer writes a check for the investment, which is deposited with an escrow company,[15] and receives a one-year, fixed-rate TLC instrument;[16] (2) the escrow company clears the funds and transfers the funds to a trust account at an FDIC insured bank; (3) TLC bids on a particular tax lien[17] and has the bank issue a cashier's check to the municipality where the tax lien is purchased; (4) the municipality issues a deed in the

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[14] TLC advertised that it purchased tax liens in states where the tax statutes provided for a favorable redemption period and redemption penalty and specifically cited Texas as an example of a state with a favorable redemption period and penalty. (JX-15, pp. 3, 9). In Texas, the redemption period was 180 days and the penalty amount was 25% of the lien. (Tr. p. 470).

[15] The invested funds were supposedly deposited in an escrow account to be used solely to purchase tax lien certificates and tax lien deeds. (Tr. p. 440). The funds were actually used to pay prior investors and to pay the personal expenses of TLC officers, including financing a football stadium for the high school of the CEO's son. (Tr. pp. 460-461).

[16] The TLC instruments required a minimum investment of $20,000, had a one-year term, and had a fixed-interest rate. (Stip. at ¶6). The selling broker determined the fixed-interest rate, ranging from 9% to 12%, which a particular customer received. (JX-13, pp. 1-4). The lower the interest rate for the customer, the higher the broker's commission rate. (Tr. p. 458).

The TLC instruments were labeled "promissory notes" or "real estate investment agreements." (JX-32, pp. 1-2, 5-6). Some of Respondent's TLC customers received promissory notes; others received real estate investment agreements. (JX-35, pp. 1-3; JX-36, pp. 12-13). The terms of the TLC promissory note and the TLC real estate investment agreement were identical and reflected a promise by TLC to pay the lender a definite sum of money at a specified time. (JX-32, pp. 1-2, 5-6).

name of TLC and the investor, i.e., a tenant-in-common deed; (5) TLC issues a property letter to the investor listing the address of the property that is the subject of the investor's purchased lien; (6) TLC issues a warranty deed to the investor, verifying the purchase; (7) the property is redeemed;[18] and (8) the investor either receives his principal and interest in 365 days or rolls over his investment into another TLC instrument. (JX-15, p. 5).

b. Howey Test for Securities

Respondent stipulated that the TLC instruments issued to the investors were securities. (Stip. at ¶12). In 2001, the United States District Court for Central California in SEC v. TLC Investments & Trade Co., et al[19] determined that the TLC instruments were securities using the SEC v. W. J. Howey Co.[20] analysis. The Hearing Panel adopts the District Court's finding that the TLC instruments are securities.

Howey establishes that an investment contract is a security when it involves (1) an investment of money, (2) in a common enterprise, and (3) with an expectation of profits from the management of others. Respondent argued that he initially did not believe the TLC instruments were securities because there was no common enterprise,

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[17] TLC represented that it only purchased tax liens on single-family residences in good neighborhoods. (JX-32, p. 14). TLC supposedly conducted site visits of the properties to be available at the tax lien auction to verify locations of the properties and to interview homeowners to determine their resolve to redeem their property. (JX-32, pp. 11, 14).

[18] If the owner failed to redeem the property, TLC indicated that it would immediately sell the property at a price high enough to ensure that the investor received the contracted interest. (JX-23, p. 16). TLC advertised that it attempted to purchase a tax lien at a cost of typically less than 50% of the fair market value of the underlying property. (JX-23, p. 14).

[19] 179 F. Supp. 2d 1149; 2001 U.S. Dist. LEXIS 19924 (9th Cir., Oct. 15, 2001).

[20] 328 U.S. 293 (1946), reh'g denied, 329 U.S. 819 (1946).

i.e., the tax liens and funds of the various customers were not pooled together. (Tr. p. 440, 500).

Finding that the TLC instruments clearly involved an investment of money with an expectation of profits from the management of others,[21] the Hearing Panel also finds that the TLC plan was a common enterprise. The Ninth Circuit recognized two types of common enterprises: "vertical commonality," where the fortunes of the investors and the promoter are linked, and "horizontal commonality," where multiple investors pool their funds and receive a pro rata distribution.[22] Pursuant to the TLC structure, there was vertical commonality. In fact, TLC advertised: "TLC makes a profit only when the investor makes a profit." (JX-23, p. 14).

Accordingly, consistent with the findings of the District Court in SEC v. TLC Investments & Trade Co. the Hearing Panel finds that there is a common enterprise, and the TLC instruments are securities, satisfying each of the three elements of Howey.[23] (JX-31, p. 12).

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[21] TLC chose the tax lien property to be purchased and invested in the property jointly with the investor. (JX-12). If the property owner did not redeem the property, TLC was responsible for taking the necessary actions to sell the property at a profit, the proceeds of which were to be used to pay the investor. (Id.).

[22] Hocking v. Dubois, 885 Fed. 1449, 1455 (9th Cir. 1989).

[23] The Hearing Panel notes that, in granting the SEC's motion for summary judgment and entry of permanent injunction, the District Court in SEC v. TLC Investments & Trade Co., et al, did not discuss (i) whether the TLC instruments should properly be characterized as promissory notes rather than investment contracts, or (ii) the form of the TLC instrument, i.e., real estate investment agreement or promissory note. (JX-31). In any event, the Hearing Panel also finds that, even if the TLC instruments were deemed to be promissory notes, they would be securities pursuant to the "family resemblance" analysis of Reves v. Ernst & Young, 494 U.S. 56 (1990), reh'g denied, 494 U.S. 1092 (1990).

3. Respondent participated in the sale of TLC instruments without prior notice to his member firm

On July 1, 1998, Respondent began selling TLC instruments to his customers. (Stip. at ¶2). Respondent admitted that he did not provide any type of notice to Securities Network prior to soliciting his customers to purchase the TLC instruments. (Tr. p. 477). Respondent admitted that the TLC sales were outside the regular scope of his employment with Securities Network. (Stip. at ¶13). Respondent admitted that he received compensation for his participation in the sales. (Stip. at ¶4). Respondent admitted that he did not receive approval from Securities Network prior to his participation in the sales. (Stip. at ¶14).

The documentary evidence confirmed that, between July 1, 1998 and March 29, 1999, Respondent (i) participated in 104 private sales of $6.8 million in TLC securities to 93 individuals, (ii) received $400,144 in commissions for the private securities transactions, (iii) failed to provide Securities Network with prior written notice of the transactions, and (iv) failed to receive approval of Securities Network to participate in the transactions.

Accordingly, the Hearing Panel finds that Respondent violated Rule 3040 by participating in private securities transactions without providing prior notice to his firm or obtaining prior approval from his firm for the transactions. Respondent's violation of Rule 3040 is also a violation of Rule 2110's requirement to "observe high standards of commercial honor and just and equitable principles of trade."[24]

[24] District Bus. Conduct Comm. for Dist. Number 8 v. Norman M. Merz, Complaint No. C8A960094 (NAC, Nov. 20, 1998).

III. Sanction

The NASD Sanction Guidelines relating to private securities transaction violations recommend a fine ranging from $5,000 to $50,000, and provide that adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial benefit.[25] The Sanction Guidelines recommend that the adjudicator consider suspending the respondent for up to one year, and, in egregious cases, consider a longer suspension or barring the respondent.[26] Arguing that Respondent's actions were especially egregious, Enforcement requested that Respondent be barred and ordered to disgorge his $400,144 in commissions to his customers.

Respondent argued that his actions were not egregious because, at the time of the sales of the TLC instruments, he reasonably believed that they were not securities, and because he supposedly filed an outside business activity disclosure form, disclosing his participation in TLC sales, to Securities Network on August 21, 1998.

After reviewing specific aggravating factors and finding a lack of mitigating factors, the Hearing Panel found that Respondent's misconduct was egregious and worthy of a bar.

A. Specific Considerations for Private Securities Transactions

In determining what sanctions should be imposed, the Hearing Panel considered the five specific considerations listed in the NASD Sanction Guidelines for Private Securities Transactions: (1) whether the respondent had a proprietary or beneficial interest in, or was otherwise affiliated with the issuer; (2) whether the respondent

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[25] NASD Sanction Guidelines, p. 19 (2001).

[26] Id.

attempted to create the impression that the employer sanctioned the activity; (3) whether the selling away involved customers of the employer; (4) whether the respondent provided the employer with verbal notice of all relevant factors of the transaction;[27] and (5) whether respondent sold the products at issue after prior rejection of the products by the member firm. The Hearing Panel found three of the five specific considerations in this case aggravating.[28] First, Respondent created the impression that Securities Network sanctioned the sales. Respondent advised his customers of the TLC instruments mainly during his routine conversations with his existing customers. (Tr. p. 509). Consequently, Respondent offered and sold the TLC instruments from his Securities Network office, primarily to his existing customers in his capacity as their Securities Network adviser. Second, the private securities transactions involved numerous customers of Securities Network. Although Respondent stipulated prior to the Hearing that approximately one-third of the 93 customers were Securities Network customers, Respondent testified at the Hearing that the vast majority of the 93 customers were Securities Network customers. (Tr. p. 509; Stip. at ¶3). And third, Respondent did not orally disclose his involvement with TLC even though, as explained below, he had repeated opportunities to do so.

B. Additional Aggravating Factors

The Hearing Panel further determined that the following additional factors were also aggravating.[29]

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[27] Id.

[28] The evidence established that Respondent did not have a proprietary or beneficial interest in, and was not otherwise affiliated with, the issuer of the notes. (Stip. at ¶11). There was no evidence presented that Securities Network had previously prohibited the sale of the TLC instruments.

[29] NASD Sanction Guidelines, Principal Consideration Nos. 8-9, 11-13, 17-18, pp. 9-11 (2001).

1. Extended Length of Time and Number of Separate Violations

Respondent engaged in the misconduct over an extended period of time, approximately nine months. (Exhibit A to Stip.). Respondent engaged in numerous acts of misconduct, executing more than 100 separate transactions. (Id.).

2. Substantial Injury to Investing Public While Substantial Monetary Gain to Respondent

The misconduct resulted in injury to the investing public.[30] According to Respondent, the investors' losses were in the millions. (Tr. p. 465). The TLC receiver reported that investors had recouped less than 14% of their investment. (CX-5; Tr. p. 538). At the same time, Respondent's misconduct resulted in substantial monetary gain to Respondent totaling $400,114 in commissions. (Exhibit A to Stip.).

3. Respondent's Lack of Candor

The Hearing Panel was also very concerned by Respondent's lack of candor. The Hearing Panel noted at least three separate examples: (i) Respondent's statement that his nondisclosure was inadvertent; (ii) his statement that he submitted information about TLC to Securities Network in August 1998; and (iii) his statement that he discontinued soliciting TLC instruments after April 1, 1999.

a. Respondent's Failure to Disclose Was Intentional

Respondent contends that his failure to discuss the TLC instruments with Securities Network was simply an oversight. The Hearing Panel, however, finds that

[30] In DOE v. Roger A. Hanson, Complaint No. C81000059, 2002 NASD Discip. LEXIS 5 (2002), the National Adjudicatory Counsel found that the customer's losses were caused by the poor performance of the investments. In this case, the Hearing Panel finds that, but for Respondent's misconduct, Respondent's customers would not have invested in the TLC Ponzi scheme and would not have suffered any losses.

Respondent was aware of his obligation to disclose the TLC transactions and that he repeatedly and intentionally failed to do so.

(1) <u>Aware of Obligation to Disclose</u>

From September 1997 to April 1998, Respondent operated California Financial as an office of supervisory jurisdiction for Securities Network. (JX-4). Pursuant to his agreement with Securities Network, Respondent agreed to notify Securities Network in writing prior to engaging in any employment relating to the sale of securities, either directly or indirectly, or relating to any other activity that would cause a conflict of interest with Securities Network.[31] (JX-4, p. 2). The agreement also provided that Securities Network would maintain a list identifying the products that were approved for sale by Securities Network representatives. (<u>Id.</u>). The TLC instruments were not on the approved product list. (Stip. at ¶13; Tr. pp. 215-216).

Jeffrey Currey, employed by Securities Network in its Compliance Department from November 1995 to July 2000, testified that Securities Network spent a great deal of time advising its representatives on the issues of outside business activities and selling away.[32] (Tr. pp. 270, 285). For example, when Respondent joined Securities Network, he received a copy of Securities Network's Compliance and Operations Manual Revised May 1995 ("Manual"), which included a number of sections addressing the issue of investments. (Tr. pp. 472-473). Section 202 of the Manual provided that representatives were prohibited from selling securities that had not been approved by Securities

[31] The agreement also provided that Respondent would familiarize himself and comply with the NASD rules. (JX-4, p. 2).

[32] Currey further testified that representatives at Securities Network should have known to call the Compliance Department if there was any question about whether a particular investment was a security.

Network.[33] (CX-2, p. 13). Section 202 of the Manual also provided a warning to representatives about products that were represented as "non-securities," but which were "non-registered securities."[34] (Id.). Section 302 of the Manual provided that representatives were prohibited from accepting or receiving compensation in connection with any investment without the prior written consent of Securities Network.[35] (CX-2, p. 14).

(Tr. p. 319).

[33] Section 202 stated:

> An approved product is on[e] which has been reviewed and approved by a Due Diligence Officer in the Home Office and reviewed for adequacy of investigation by the executive committee. . . . Representatives may NOT solicit sales in or sell any products which have not been approved by the Home Office. . .
>
> If there is a product in which you are interested which does not appear on the approved product list, please contact the Home Office about the possibility of getting it approved. (CX-2, p. 13).

Respondent testified that, after reading the Manual, he understood the term "any product" to mean "any securities product." (Tr. pp. 473-474).

[34] Section 202's warning stated:

> WARNING: There are products represented as "non-securities" that in fact are really "non-registered securities" in violation of state and/or regulatory requirements. These purported "non-securities" carry extremely harsh penalties to Registered Representatives (and sometimes the Broker-Dealer) by the courts, the regulatory authorities, and the Broker-Dealer. If there is any doubt at all, please contact the Home Office promptly. A "rule of thumb" question that should be asked to alert any Registered Representative to a potential security/non-security problem would result in a positive response to the following question: Does the client lose direct and constant control of his/her money in anticipation of potential profit? (CX-2, p. 13).

[35] Section 302 of the Manual provided that registered representatives were specifically prohibited from:

> Accepting or receiving, directly or indirectly, from any person, firm, corporation or association other than the Company, compensation of any nature as a bonus, commission, fee, gratuity, or other consideration, in connection with any transaction, in the investment field [or] what might be construed to be an investment, except with the prior written consent of the Company . . . . A definition of investment for purpose of this rule includes any security, as defined in Section 2 of the Securities Act of 1933, real or personal property which can be construed in commonly used terminology to be an investment (an outlay of money for income or profit), e.g., gold, silver, diamonds, paintings, antiques. (CX-2, p. 14).

Additionally, on December 30, 1997, Respondent received a Securities Network newsletter, which, among other things, warned its representatives about private securities transactions. (JX-16). The newsletter stated:

> First of all, if someone is trying to raise capital for a business or development, it will more than likely meet the definition of a security. If it is even close to being a security, any involvement by a registered person would likely be determined as a private securities transaction. (JX-16, p. 1).

Respondent stated that he understood the concept of private securities transactions as set forth in the newsletter. (Tr. pp. 477-478).

(2) __Repeated Failures to Discuss TLC with Securities Network__

There were at least four separate opportunities -- March 1998, May 1998, June 1998, and November 1998 -- when Respondent should have disclosed TLC to Securities Network.

Despite viewing the TLC instruments as a unique product with an unusually high rate of return, Respondent failed to call the Compliance Department to discuss the TLC instruments in March 1998 when he first heard of TLC.[36] (Tr. pp. 448, 470, 522).

Three months after being introduced to the TLC instruments, Respondent attended a Securities Network compliance seminar conducted by Darla Goodrich in May 1998.[37] (Tr. pp. 400, 478). At the seminar, Goodrich presented a slide presentation, which included the statement, "No employment or <u>compensation</u> from any other person without prompt written notice." (Tr. p. 208; JX-18, p. 19). Goodrich testified that she orally made

[36] Respondent confirmed that Securities Network's Compliance Department was "pretty good about getting back" when he asked them questions. (Tr. p. 476).

[37] Darla Goodrich was the Chief Compliance Officer of Securities Network from January 1, 1998 to September 24, 1998. (Tr. pp. 181-182).

clear that if a representative was going to be compensated for any activity that he would have to get firm approval for the activity. (Tr. p. 236). Again, in May 1998, Respondent failed to discuss TLC with the Securities Network Compliance Department, although he was in the process of investigating TLC. (Tr. p. 503).

One month later on June 11, 1998, Brad Keeter a Securities Network compliance examiner conducted a routine audit of Respondent's office. (Stip. II at ¶2). Again, Respondent never disclosed to Keeter his ongoing efforts to sell TLC instruments. (Stip. II at ¶2). Respondent testified, "[i]t didn't occur to me" to mention TLC when the auditors were there. (Tr. p. 455).

On November 23, 1998, Respondent responded in writing to the September 23, 1998 Keeter audit report, in which Keeter summarized the results of the June 11, 1998 review of Respondent's office.[38] (JX-6; JX-8). In his response, Respondent indicated that the outside business disclosure requirements would be adhered to per Keeter's audit report. (Id.). Respondent did not disclose his relationship with TLC in his response. (Id.).

b. Respondent Did Not Submit TLC Material to Securities Network in August 1998

Respondent contends that he forwarded information concerning TLC to Securities Network 40 days, not nine months, after he began selling TLC instruments.[39] (Tr. pp. 461-462). Three Securities Network compliance employees--Bellaire, Goodrich, and

[38] The audit report indicated that copies of outside business activity disclosure forms were enclosed and that signed forms should be returned with Respondent's response. (JX-6, p. 4).

[39] Respondent testified that he directed his staff to send to Securities Network three signed outside business activity disclosure forms, which listed TLC and had attached thereto approximately 20 pages of TLC marketing materials. (Tr. pp. 461-462). Respondent and two other representatives in Respondent's office, who sold TLC instruments, supposedly signed the disclosure forms in August 1998. (RX-1, pp. 3-5). In support of his testimony, Respondent's two employees, Jones and Woodward, testified that Jones sent the TLC material to Securities Network on August 21, 1998. (Tr. pp. 334, 366).

Currey--testified that they did not receive the outside business activity disclosure forms or the TLC documents allegedly contained in the August 21, 1998 package. (Tr. pp. 71-72, 78, 217, 282). Respondent stipulated that Keeter, another compliance employee, did not know anything about his involvement with TLC. (Stip. II at ¶2).

Although there is evidence that a package was sent to Securities Network on August 21, 1998,[40] the Hearing Panel finds that no material concerning TLC was included in the package. The Hearing Panel finds the testimony of the Securities Network compliance employees more credible than the testimony of Respondent and his two employees.[41]

The Hearing Panel noted that some of the documents, particularly the TLC America documents, which Respondent testified he submitted to Securities Network in the August 21, 1998 package, were not created until after that date. Respondent testified that TLC materials included: (1) a TLC America real estate investment agreement; (2) a TLC America producing general agent broker agreement; (3) a TLC America client information sheet; and (4) an escrow agreement with Fortune Escrow, Inc.[42] (RX-1, pp. 6-

[40] In an unsigned memorandum that was provided to NASD staff in December 1999, Jo Anne Felty, a Securities Network employee, confirmed that she had checked off everything on an August 21, 1998 packing slip as received, including the disclosure forms. (Tr. pp. 77, 176, 327, 332; JX-17, p. 2; JX-18, p. 11; RX-5). Felty was unavailable to testify at the Hearing. (Tr. pp. 71-72). The Hearing Panel noted that the alleged packing slip, prepared by Jones only listed the disclosure forms, not the TLC material. (JX-17, p. 2; Tr. p. 355). In addition, the fax banner line on the August packing slip appeared to be different from the fax banner line on other packing slips that Respondent submitted to support his testimony concerning the routine procedure of enclosing packing slips in California Financial packages sent to Securities Network. (RX-1, p. 2; RX-2; Tr. p. 354).

[41] The compliance employees testified that if the TLC material had been received by Securities Network's mailroom, the material would have been sent to the Compliance Department. (Tr. p. 99, 234-235). Bellaire testified that none of the three representative files included copies of the purported disclosure forms or the TLC material. (Tr. p. 65).

[42] The materials also included: (1) a TLC Marketing presentation entitled "Keys to TLC's Specific Project"; and (2) a TLC Marketing presentation entitled "Investment Overview"; (3) an excerpt from the State of

11; Tr. pp. 461-462). TLC America was not even formed until November 1998.[43] (JX-25, p. 1). In addition, TLC did not begin using Fortune Escrow as its escrow agent until January 1999.[44]

Bellaire testified that Respondent told him at the April 1, 1999 special audit that he had not told Securities Network of the TLC instruments because he was concerned that Securities Network would not add the TLC instruments to its approved list.[45] (Tr. pp. 62-63). Respondent denied making that statement. (Tr. p. 553). Having observed both Respondent and Bellaire, the Hearing Panel found Bellaire's testimony more credible. Furthermore, as soon as the Compliance Department received information concerning Respondent's participation in the sale of TLC instruments in March 1999, it directed Respondent to stop selling TLC instruments and subsequently terminated him. This strongly suggests that Securities Network did not have prior notice of Respondent's activities.

Texas Tax Codes; (4) an opinion of counsel for TLC, dated March 17, 1997, which stated the TLC transactions and investments were not securities within the meaning of Rule 14(b) of the Securities and Exchange Act of 1934; (5) a letter, dated March 10, 1997, from a CPA, stating that during the three years he had done the accounting and tax work for TLC Investments & Trade, TLC had never shown a loss in any quarter; and (6) a copy of a completed tax lien deed showing that TLC had purchased property in Harris County, Texas at an auction on January 6, 1998 for $24,319. (RX-1, pp. 12-24; Tr. pp. 461-462).

[43] The TLC America documents would have been created after November 1998. The TLC America real estate agreement is dated "11/98" on the left bottom corner of page two of the document. (RX-1, p. 7). The TLC America producing general agent broker agreement is dated "01/99" on the left bottom corner of the document. (RX-1, p. 10).

[44] In a TLC Marketing real estate investment agreement, dated January 22, 1999, the name "Mission Valley Escrow" was marked out, and the name "Fortune Escrow" was handwritten into the document. (JX-35, pp. 1, 3).

[45] Bellaire's testimony is consistent with his April 5, 1999 memorandum that summarized his April 1, 1999 audit of Respondent's office. (JX-10, p. 2).

c. Respondent's False Denial of Continued Solicitation of TLC Instruments

Respondent falsely testified that he stopped soliciting new customers for TLC when Securities Network advised him to cease and desist selling TLC instruments on April 1, 1999. (Tr. pp. 514-515). Schedule A to the Stipulation listed the customers to whom Respondent had sold TLC instruments prior to April 1, 1999. (Stip. at ¶3). At least, five additional purchasers, who were not listed among the 93 customers on Schedule A, filed lawsuits against Respondent based on his solicitation of their investment in TLC.[46] (JX-34, pp. 7-30, 51-60, 61-77, 90-110, 111-133).

When confronted with the evidence of TLC commission checks dated after April 1, 1999, Respondent explained that the subsequent commissions he received from TLC constituted rollover residual income.[47] (Tr. p. 560). However, Respondent received eleven commission checks payable to California Financial, totaling approximately $85,000 from TLC between April 5, 1999, and June 21, 1999.[48] (JX-33, pp. 150-160). Since Respondent's earliest initial transaction was July 1, 1998, the earliest Respondent could have generated rollover income for a one-year note was July 1, 1999. Consequently, the Hearing Panel finds that the commission payouts to California Financial were likely attributable to new sales.

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[46] One of the lawsuits named not only Respondent, but also Brookstreet Securities Corporation, an NASD member that Respondent did not join until December 1999. (JX-34, p. 51; JX-3, p. 3). The lawsuits by private investors have been settled. (Tr. p. 466).

[47] Respondent testified that a number of his customers opted to rollover their TLC investment. (Tr. p. 515) The rollover was not automatic and required the customers to complete additional documentation. (Id.).

[48] The Hearing Panel also noted that the memo section of the commission checks listed dates of commissions ranging from April 2, 1999 to June 18, 1999. (JX-33, pp. 150-160).

5. Lack of Concern and Lack of Remorse

Lastly, the Hearing Panel noted Respondent's apparent lack of concern and remorse as aggravating factors. The Hearing Panel believes that Respondent, initially thinking that the TLC instruments were a safe investment[49] and focusing on the commission to be earned,[50] did not care whether the TLC instruments were securities. Respondent utterly failed to appreciate the importance of Rule 3040. The SEC, in Anthony J. Amato, 45 S.E.C. 282, 285 (1973), has explained the importance of Rule 3040 as follows:

> Where employees effect transactions . . . outside of the normal channels and without disclosure to the employer, the public is deprived of the protection which it is entitled to expect . . . [S]uch conduct is not only potentially harmful to public investors, but inconsistent with the obligation of the employee to serve his employer faithfully [and the] employer's interest may be adversely affected. At the least, the employer should be enabled to make that determination.

Subsequently when faced with red flags regarding the representations made by TLC, Respondent still did not seek the advice of Securities Network or do any further due diligence. For example, in January 1999, Respondent received a financial statement from TLC indicating that the TLC entities had incurred a net loss for December 31, 1998 of $2,102.84. (JX-25, p. 3). Nevertheless, Respondent continued to solicit customers to purchase TLC

[49] Respondent's due diligence consisted of reviewing: (i) the TLC marketing materials, (ii) certain tax lien deeds, (iii) certain property appraisals, and (iv) site visitation reports. (Tr. p. 493). Respondent also spoke with the president and CFO of TLC several times, visited TLC's offices, and spoke with persons involved in actually purchasing the tax liens at auction. (Tr. pp. 433-434). In May 1997, Respondent listened to a conference call with a TLC attorney who described in detail the tax lien process. (Tr. p. 437).

[50] In 1998, approximately 40% of Respondent's income was derived from the TLC sales. (Tr. p. 514). In 1999, the percentage of Respondent's income derived from TLC sales had increased to approximately 50%. (Id.).

instruments, to collect commissions, and to describe the TLC instruments as "guaranteed investments."

Even after three broker-dealers--Securities Network, Cambridge Investments,[51] and Brookstreet Securities Corporation[52]--expressed concern about the TLC instruments, Respondent continued to solicit and tout the securities as government-guaranteed investments to unsophisticated investors, the vast majority of whom were retirement age. (Tr. pp. 492, 554).

During the Hearing, Respondent failed to acknowledge any responsibility for the losses suffered by his customers.

C. Lack of Mitigating Factors

As mitigating factors, Respondent argued that he reasonably believed that the TLC instruments were not securities, and that he submitted to Securities Network an outside business activity form on August 21, 1998.

1. Belief that TLC Instruments were Not Securities Was Not Reasonable

Respondent testified that it was reasonable for him to determine that the TLC instruments were not securities based on (i) the structure of the transactions, i.e., the TLC

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[51] On May 7, 1999, Respondent became associated with NASD member Cambridge Investment Research, Inc. and was directed by Cambridge Investment Research, Inc. not to solicit any more TLC business. (JX-3, p. 8: Tr. p. 541). Subsequently, Respondent directed TLC to pay his rollover income to his spouse, and TLC America issued 20 commission checks, totaling $324,484, to his spouse from June 29, 1999 to November 22, 1999. (Tr. p. 531; JX-33, pp. 51-70). The $324,484 is not included in the $400,144 in commissions that Respondent received while associated with Securities Network.

[52] On December 9, 1999, Respondent became associated with Brookstreet Securities Corporation. (JX-3, p. 6). While Respondent was employed by Brookstreet Securities Corporation from December 1999 to July 2000, Respondent failed to disclose on his outside business form with Brookstreet that he was receiving TLC commission checks. (Tr. p. 536; JX-3, p. 3). From January 3, 2000 to June 27, 2000, Respondent deposited 29 commission checks, totaling $339,556, payable to his spouse for his rollover income into California Financial's bank account. (JX-33, pp. 71-99). The $339,556 is not included in the $400,144 in commissions that Respondent received while associated with Securities Network.

instruments did not resemble other securities such as limited partnership interests, stocks, and bonds, and TLC undertook to keep a customer's funds and tax liens separate from other customers, and (ii) the legal opinion provided by TLC in its marketing material. (Tr. pp. 440, 448-449).

First, although Respondent testified that in his 15 years in the securities industry he had never seen anything like the TLC instruments or anything remotely resembling what TLC was doing, he believed the tax lien investment was an investment in real estate and not a security.[53] (Tr. pp. 448, 483). For his belief that the TLC instruments were real estate investments, Respondent relied, in part, on the tenant-in-common deed contained in TLC's marketing materials, as set forth in joint exhibit 24. (Tr. pp. 445-446, 490). Even a cursory review would reveal that the purported deed, dated November 6, 1997, indicated a completed purchase of property in Harris County, Texas, at an auction that was listed as occurring two months in the future on January 6, 1998. (JX-24, pp. 2-3). In addition, although the second page of the purported deed listed a customer as a joint tenant, the first page only listed TLC as the grantee and purchaser of the property. (Id.). This poor documentation should have constituted a red flag to Respondent.

Respondent emphasized that the customer funds were initially deposited in an escrow fund and "came out of the escrow account to purchase the tax liens." (Tr. p. 440). Respondent failed to acknowledge that the only condition for release of the escrow funds

[53] As an example of the real estate nature of the TLC transactions, Respondent emphasized that the customers were listed as tenants-in-common with TLC on the tax lien deeds and received warranty deeds from TLC to verify the customer purchases. (Tr. p. 488-489). The Hearing Panel noted that Respondent knew that the customers never received the tenants-in-common deeds and that the TLC-issued warranty deeds, received by the customers, were never recorded and never intended to be recorded. (Id.).

to the trust account, pursuant to the terms of the escrow agreement, was that all funds required to be deposited by the investor had been deposited. (JX-37, p. 8; Tr. p. 440). In addition, according to the terms of the TLC instruments, TLC had the authority to use the customer funds to pay fees, commissions, and interest payments. (JX-32, pp. 1, 5). This authority contradicted Respondent's understanding regarding the use of the customer funds. (Tr. p. 440). The Hearing Panel viewed this contradiction as a red flag.

Based on the structure of the transactions and the red flags, it was unreasonable for Respondent to conclude that he did not need to seek the advice of his Compliance Department before determining that the TLC instruments were not securities.

Second, the legal opinion that Respondent relied on was provided by the issuer, TLC, as part of its marketing package. (Tr. p. 449). The National Adjudicatory Counsel has determined that, under the Sanction Guidelines, it is objectively unreasonable to rely on legal advice given by interested or unqualified persons.[54] The legal opinion in this case was addressed only to TLC and was not written for the public at large. Moreover, the opinion specifically stated that it was "not intended nor should it be used as an inducement or marketing tool to solicit investors." (JX-19, p. 4). Accordingly, Respondent's reliance on the legal opinion was not reasonable.

Respondent, a registered principal for more than 10 years, should have known, in light of the numerous red flags, that he did not have enough information to make a determination that the TLC instruments were not securities without consulting the

[54] DOE v. Timothy James Fergus, Frank Thomas Devine, Richard Alan Blake, Complaint No. C8A990025, 2001 NASD Discip. LEXIS 3 (NAC, May 17, 2001), appeal docketed, Frank Thomas Devine, No 3-10530 (SEC June 15, 2001).

Compliance Department of his member firm. The fact that the TLC instruments were structured as notes and some were explicitly labeled as promissory notes should have alerted Respondent to the fact that they might be securities.[55] In addition, Respondent agreed that the TLC interest rate raised a red flag because the interest rate paid was substantially higher than rates paid on certificates of deposits or mutual funds. (Tr. p. 452). Respondent testified that he did not think the question of the TLC instruments being a security was a "close call" and if he had thought so, he would have asked Securities Network.[56] (Tr. p. 475-476). The Hearing Panel finds this statement incredible.

The Hearing Panel finds there was no reasonable basis for Respondent to determine that (i) he did not need to consult his member firm before making a determination that the TLC instruments were not securities, and (ii) he could solicit purchases of TLC instruments without the approval of Securities Network.

2. Filing of Outside Business Activity Disclosure Form

The Hearing Panel determined that Respondent did not file the outside business activity disclosure form as he asserted. Even if the Hearing Panel believed that Respondent had submitted to Securities Network the outside business activity disclosure form in August 1998, the submission of the form more than 40 days after he began soliciting sales of the TLC instruments would not be considered a mitigating factor.

[55] Id.

[56] Respondent admitted that he understood that his customers were receiving promissory notes. (Tr. p. 562).

Taking all of the above factors into consideration, the Hearing Panel determined that Respondent's misconduct was egregious and that Respondent because of his intentional or extreme reckless behavior was a danger to the investing public. Accordingly, the Hearing Panel barred Respondent and fined him $400,144 to be reduced by any amounts that had been paid in disgorgement of commissions to his customers or the TLC receiver or are paid in disgorgement within one month of the date of this decision.[57]

IV. Conclusion

Based on the evidence, the Hearing Panel barred Respondent and fined him $400,144[58] to be reduced by any amounts that had been paid in disgorgement of commissions to his customers or the TLC receiver or are paid in disgorgement within one month of the date of this decision. All proof of payment of the disgorged commissions to customers or the TLC receiver must be submitted to the staff of the NASD District Office No. 2 within 30 days of this decision becoming the final disciplinary action of NASD.

The Hearing Panel also ordered Respondent to pay the $5,141.21 costs of the Hearing, which include an administrative fee of $750 and Hearing transcript costs of $4,391.21. The fine and costs shall become due on a date set by NASD, but not earlier than 30 days after the date this Decision becomes the final disciplinary action of the

[57] See DOE v. Luther A. Hanson, Complaint No. C9A000027, 2001 NASD Discip. LEXIS 41 (NAC, Dec. 13, 2001).

[58] The fine represents the amount of financial benefit paid by TLC to Respondent when he was associated with Securities Network.

NASD. The bar shall become effective immediately upon this Decision becoming the final disciplinary action of NASD.[59]

HEARING PANEL

By: Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
September 5, 2002

Copies to:
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[59] The Hearing Panel 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.