NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. JAMES S. DAVENPORT (CRD No. 1726592), Glasgow, Kentucky, Respondent.	Disciplinary Proceeding No. C05010017 Hearing Officer—Andrew H. Perkins **Hearing Panel Decision** March 4, 2002

A formerly registered representative violated NASD Conduct Rule 2110 by making false representations to his firm. The Hearing Panel fined the Respondent $10,000 and suspended him from associating with any member firm in any capacity for nine months.

Appearances

Mark P. Dauer, Regional Counsel, New Orleans, Louisiana, and Rory C. Flynn, Chief Litigation Counsel, Washington, DC, for the Department of Enforcement.

James S. Davenport appeared on his own behalf.

DECISION

The Complaint charges Respondent James S. Davenport ("Davenport" or the "Respondent") with violating NASD Conduct Rule 2110 by submitting false reports regarding his financial activities to his firm, J.J.B. Hilliard, W.L. Lyons, Inc. ("Hilliard" or the "Firm"). The Complaint alleges that Davenport, on three separate occasions,

submitted a "Prohibited Activities Listing" form on which he represented that he had not borrowed money from any of the Firm's customers when, in fact, he had borrowed approximately $1,536,000 from 26 customers. Davenport admitted the allegations and requested a hearing on sanctions.

I. PROCEDURAL HISTORY

The Department of Enforcement ("Department") filed the Complaint against Davenport on June 11, 2001; Davenport filed his Answer on June 18, 2001. Davenport's Answer consisted of a letter stating that he did not contest any of the factual allegations and requesting a hearing on sanctions.

In accordance with Davenport's request, a hearing on sanctions was held on December 12, 2001, in Louisville, Kentucky before a Hearing Panel comprised of the Hearing Officer and two current members of the District Committee for District 5. The Department introduced the Parties' signed Stipulations and six exhibits into evidence.[1] Davenport called three witnesses and testified in his own defense.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. The Respondent

Davenport entered the securities industry in June 1987 when he joined Hilliard.[2] He registered as a General Securities Representative with Hilliard on September 24, 1987, and remained with the Firm until he left to join Dean Witter Reynolds Inc. ("Dean Witter") in July 1999. Davenport was associated with Dean Witter from July 30, 1999, until February 1, 2000, at which time he was discharged due to the loans that are the

[1] The hearing exhibits are referenced as: "CX- ___." The hearing transcript is referenced as: "Tr. at ___."

[2] CX-6, at 3.

subject of this proceeding.[3] He was registered as General Securities Representative with Dean Witter from August 16, 1999, until March 1, 2000.[4] Since then, he has not been registered with the National Association of Securities Dealers, Inc. ("NASD").

Davenport's Central Registration Depository ("CRD") record shows no prior disciplinary history, and the evidence shows that he cooperated fully with Dean Witter and the staff at NASD Regulation, Inc. in their investigations.[5] Moreover, none of the customers who lent Davenport money complained to Hilliard, Dean Witter, the NASD, or the Securities and Exchange Commission ("SEC").

B. Jurisdiction

NASD Regulation, Inc. has jurisdiction over this proceeding under Article V, Section 4 of the NASD By-Laws. Davenport was registered with the NASD at the time of his alleged violation, and the Department filed the Complaint on June 11, 2001, within two years of when he was last registered with the NASD.

C. Background and Investigation

There are no disputed facts.

On or about January 11, 2000, an anonymous author sent a letter to Dean Witter, with copies to the NASD and the SEC Division of Enforcement, complaining that Davenport had taken a personal loan from the author's mother and stating that it was "public knowledge throughout the community" that Davenport had borrowed money from

[3] Id. at 4.

[4] Id.

[5] CX-6; Stipulations ¶ 4; Tr. at 10.

several other of Dean Witter's customers.[6] The author requested that Dean Witter immediately repay the outstanding loans.

Davenport contends, and the Department concedes, that the letter was not written on behalf of a customer. The letter had neither a postmark nor a return address, and the "customer" referred to in the letter did not correspond to any of Davenport's customers.[7] More likely, the Department theorizes, the source is a disgruntled co-worker or someone who had some ax to grind with Davenport.[8]

Upon receipt of the letter, Dean Witter called Davenport to a meeting and confronted him with the allegations.[9] Davenport forthrightly admitted that he had loans with a number of his customers. Based on this admission, Dean Witter fired Davenport the next morning. Thereafter, on March 1, 2000, Dean Witter filed a Uniform Termination Notice For Securities Industry Registration (Form U-5) on Davenport's behalf, which stated that Dean Witter terminated Davenport because he "admitted that he had received loans from clients while employed by his prior firm."[10] Shortly thereafter, NASD Regulation opened an investigation into the circumstances surrounding Davenport's termination.

In connection with its investigation, NASD Regulation sent Davenport a request for information concerning the circumstances surrounding his termination from Dean Witter. In response, Davenport provided a detailed list of all of the loans he had with his

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[6] CX-1.

[7] Tr. at 23.

[8] Id. at 9.

[9] Id. at 23.

[10] Id. at 26; CX-6, at 6.

customers.[11] Davenport explained, as he did at the hearing, that he had started taking personal loans from his mother, friends, and high-net-worth customers to cover his losses from options trading.[12] In total, Davenport disclosed that, over several years, he had borrowed more than $1.5 million from 26 customers.[13]

Davenport further testified that he started trading OEX[14] puts and calls as early as 1994 through his account at Hilliard.[15] At first, he started out small, but as he lost money, he increased the size of his trades. By 1999, he had days where he lost as much as $125,000, and his total outstanding debt from trading losses had mounted to about $700,000.[16] Davenport testified that by early 1999 he realized that he had a "gambling problem."[17]

Apart from his OEX trading, Davenport was quite successful in the securities business. Over his 13 years at Hilliard, Davenport put together a sizeable book of business. By the time he left Hilliard, Davenport had approximately $83 million under management, and he was grossing approximately $664,000 per year in commissions.[18] Davenport estimated that this made him Hilliard's 25th highest grossing broker.[19]

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[11] CX-2.

[12] Id.

[13] Tr. at 10.

[14] The term "OEX" refers to the Standard & Poor's 100 Stock Index, which comprises stocks for which options are traded on the Chicago Board Options Exchange.

[15] Tr. at 19.

[16] Id. at 34, 37.

[17] Id. at 19, 21.

[18] Id. at 20.

[19] Id. at 18-19.

In early 1999, Dean Witter recruited Davenport. Several other Hilliard brokers had left to join Dean Witter's new Bowling Green office, and they recommended that Dean Witter open an office in Glasgow and that it recruit Davenport to join that office. At first, Davenport turned down Dean Witter's offer. But when Dean Witter increased the signing bonus to $278,000, Davenport saw it as a way to quit options trading and repay some of his loans.[20]

Davenport joined Dean Witter and quit trading options. In fact, he did not open a margin account while he was at Dean Witter. As to his signing bonus, he gave $5,000 to his secretary and $10,000 to his church.[21] He applied the balance, and $105,000 from his IRA account, to his outstanding loans.[22]

Each of the loans was evidenced by a promissory note and bore interest at a fair market rate.[23] Davenport made all the installment payments, including interest, on his various loans until Dean Witter fired him. Thereafter, Davenport spoke to each of the lenders and renegotiated the payment terms on the loans. The Department does not contest Davenport's claim that he has continued to make payments in accordance with the revised loan agreements and that none of the customers has suffered a loss.

Currently, Davenport makes about $60,000 per year selling veterinary supplies for a company owned by one of his former brokerage customers.[24] The aggregate unpaid

[20] Id. at 21-22, 27-28.

[21] Id. at 27.

[22] Id. at 28.

[23] CX-2.

[24] Tr. at 28, 32.

balance on the outstanding loans is approximately $400,000.[25]

D. Discussion

Hilliard had a written policy in its Compliance Manual that prohibited employees from borrowing money from a customer of the Firm.[26] To assure compliance with this and other specified prohibitions, each year the Firm requested its employees to complete and sign a "Prohibited Activities Listing" form. Question 9 asked whether Davenport had borrowed any money from a customer.[27]

The Complaint alleges, and Davenport admits, that he signed and submitted three false Prohibited Activities Listings forms. The forms dated June 5, 1997, May 5, 1998, and July 19, 1999, each failed to disclose the loans he had taken to cover his OEX trading losses.[28] Accordingly, the Complaint charges that Davenport thereby violated NASD Conduct Rule 2110, which provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."[29] The gravamen of the charge is Davenport's false statements, not his borrowing from customers, because, as the Department carefully points out, there is no statute, regulation, or rule that prohibits such borrowing.[30]

The Hearing Panel finds that Davenport violated NASD Conduct Rule 2110 by submitting false certifications that he had not borrowed money from the Firm's

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[25] Id. at 35.

[26] CX-3.

[27] CX-5.

[28] The May 5, 1998, form does disclose that a customer carried his home loan. (CX-5, at 3.)

[29] NASD Manual (CCH) at 4111 (2000).

[30] Cf. Robert J. Jautz, 48 S.E.C. 702 (1987) (failure to make timely repayment of loan to customer is not a violation of Article III, Section of the NASD's Rule of Fair Practice (now NASD Conduct Rule 2110) without evidence of bad faith or unethical conduct).

customers. Conduct Rule 2110 requires adherence to "high standards of commercial honor and just and equitable principles of trade."[31] The Rule states a broad ethical principle that is not limited to rules of legal conduct.[32] A violation of Conduct Rule 2110's ethical requirements may be found where no legally cognizable wrong occurred.[33] In other words, the NASD has authority to impose sanctions for violations of "moral standards," such as in this case, even if there was no "unlawful" conduct.[34]

Violations of federal securities laws and NASD Conduct Rules are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations.[35] In contrast, failure to honor a contractual obligation violates Conduct Rule 2110 only if the surrounding facts and circumstances indicate that the conduct was unethical.[36] In such cases, the NASD and the SEC employ the concepts of excuse, justification, and "bad faith" to determine whether the conduct is unethical because it is beyond their function to determine private contract rights.[37] The proper regulatory concern is "whether the member's conduct in question violates standards of fair

[31] Section 15A of the Securities Exchange Act of 1934 (the "Exchange Act") requires the NASD, as a registered securities association, to have and enforce rules that "promote just and equitable principles of trade."

[32] Timothy L. Burkes, 51 S.E.C. 356 (1993), aff'd mem., Burkes v. SEC, 29 F.3d 630 (9th Cir. July 24, 1994).

[33] Id.

[34] Benjamin Werner, 44 S.E.C. 622 (1971).

[35] Department of Enforcement v. Aleksandr Shvarts, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12-13 (June 2, 2000).

[36] Id. at *13.

[37] Id.

dealing."[38] Thus, not every breach of contract violates Conduct Rule 2110: the touchstone is whether the member acted in good faith.[39]

Applying the foregoing principles to this case, the Hearing Panel finds that Davenport violated Conduct Rule 2110 because he intentionally lied to his Firm to conceal his borrowing practices. Davenport candidly admitted that he submitted the false Prohibited Activities Listing forms to keep from being fired.[40] Davenport did not attempt to justify or excuse his conduct: he knew that it was against Firm policy to borrow from the Firm's customers, and he knew that it was wrong to lie on the annual compliance forms.

III. SANCTIONS

The more difficult question presented by this case is that of sanctions. As a starting point, the Hearing Panel notes that there is no sanction guideline for this misconduct. Moreover, the Department concedes that there is no NASD or SEC decision directly on point. Lacking this guidance, the Department focuses on the amount and number of loans Davenport had with his customers over several years. The Department argues that these factors support its view that Davenport engaged in serious misconduct. Thus, the Department requests that the Hearing Panel impose a $10,000 fine and a one-year suspension in all capacities.[41] The Department does not request a greater fine because it does not want to divert assets that Davenport could otherwise use to repay the customer

[38] Samuel B. Franklin & Co., 38 S.E.C. 113, 116 (1957).

[39] Buchman v. SEC, 553 F.2d 816, 820-21 (2d Cir. 1977) (A breach of contract is permissible if "colorably justified by the confusion as to the true state of the market and as to the applicable law.").

[40] Tr. at 24.

[41] Id. at 61-62. Davenport pointed out that the Department had offered to settle the case with a six-month suspension.

loans. The Department also requests that Davenport be ordered to repay the loans in full or demonstrate that he has set up a satisfactory payment plan before he is able to re-enter the securities industry.[42]

The Hearing Panel also is concerned about Davenport's ability to repay the loans, and it believes that the proper emphasis is on Davenport's violative conduct, not on the loans themselves, which do not violate any law, regulation, or rule. Davenport's offense is his failure to disclose the loans when asked to do so on the annual Prohibited Activities Listing forms; he is not charged with any inappropriate conduct with the customers. The Hearing Panel also finds it significant that the Department concedes that the customers have not suffered a financial loss. Thus, the Department's emphasis on the size and number of loans is misplaced.

The Hearing Panel focused on the following General Principles Applicable to all Sanction Determinations: (1) disciplinary sanctions are remedial in nature and should be designed to deter future misconduct and to improve overall business standards in the securities industry; and (2) Adjudicators should tailor sanctions to respond to the misconduct at issue.[43] The Hearing Panel also focused on several of the Principal Considerations in Determining Sanctions that it found particularly applicable to the unique facts and circumstances of this case.[44] Neither of his firms nor any of his customers lost any money. Davenport was forthright and honest about his activities when confronted by his supervisors at Dean Witter, and he was extremely cooperative with

[42] Id. at 62.

[43] NASD Sanction Guidelines 3-4 (2001 ed.) < http://www.nasdr.com/3100.asp>.

[44] Id. at 9-10.

NASD Regulation staff during their investigation. Finally, Dean Witter disciplined Davenport by firing him when it learned of his misconduct at Hilliard. As a result, he has been out of the industry since February 1, 2000.

The Hearing Panel further finds a number of other compelling mitigative factors in this case. First, the Hearing Panel places a great deal of consideration on the fact that Davenport had taken positive steps to deal with his "gambling problem" before Dean Witter discharged him. Davenport seized the opportunity to use the signing bonus Dean Witter offered to pay down some of the loans, and, more importantly, he stopped trading options when he left Hilliard. Thus, Davenport, on his own, had removed himself from the situation that had led to his submitting the false statements to Hilliard.

Second, given the fact that Hilliard, not the public, suffered the wrong here, the Hearing Panel finds that the fact that Hilliard knew about one loan and had reason to know about the others is significant. Davenport testified that his branch manager confronted him about one of the loans four or five years before he left Hilliard.[46] And the compliance department called Davenport three or four times about the size of his losses to ask how he could afford to lose so much money and whether he was "OK." Since all of the trades went through Hilliard, the Firm was in a position to monitor the size of Davenport's positions. Despite the indications that Hilliard was aware of Davenport's trading problems and his need to cover his substantial losses, the Firm took no action. While this does not excuse Davenport's conduct,[47] the Hearing Panel believes it is a

[45] Tr. at 30.

[46] Id. at 24-26.

[47] The Hearing Panel further notes that Davenport does not seek to absolve himself of responsibility on this ground.

mitigating factor. Certainly, if the Firm had stepped forward and investigated further, the problem could not have gone on as long. Furthermore, to the extent that Hilliard's policy against customer loans was designed to protect its interests, Hilliard had adequate information to do so. However, Hilliard appeared to have been more anxious to keep a large producer than to upset the apple cart by questioning him further.

Third, Davenport was a valued employee at both his firms and a community leader for the 13 years he was in the industry. For example, he was president of the local Rotary Club and a member of the local industrial development board.[48]

Finally, the Hearing Panel considered Davenport's sincere remorse and his desire to re-enter the securities industry so that he could pay off his loans sooner. In this regard, Davenport asks the Hearing Panel to refrain from extending his time out of the industry. In his view, he already has served a two-year suspension.

In support of his request, Davenport presented three of his former customers to testify on his behalf. CP and NP, husband and wife, testified that they first started investing with Davenport more than eight years ago. They testified that Davenport always had been honest with them, that he had helped with their investing, and that he had become like a son.[49] As a result, when Davenport approached them for a loan, they were happy to help. Over the course of several years, they lent Davenport a total of $200,000. Davenport was never late on his payments. In conclusion, CP said that if Davenport ever got back into the securities business, he would be one of his first customers.[50]

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[48] Tr. at 30.

[49] Tr. at 45. All of the loans were based on Davenport's personal relationship with his customers.

[50] Id. at 44.

NL testified in a similar vein. She and her husband also invested with Davenport for many years, and they became friends. When Davenport told them that he had lost some money and needed a loan, they were happy to make the loan out of friendship.[51]

In consideration of these factors, the Hearing Panel concludes that Davenport should be given a $10,000 fine and a nine-month suspension. With respect to the suspension, the Hearing Panel determines that Davenport should be given credit for the time he has been out of the industry.[52] In addition, upon rejoining a member firm, Davenport should be restricted from leveraged trading in his own account. The Hearing Panel considers this restriction appropriately remedial given Davenport's admitted "gambling problem."

In setting the suspension, the Hearing Panel looked to other Sanction Guidelines involving similar misconduct. The Hearing Panel found that for a variety of misconduct involving the false reporting of information the typical recommended suspension is a maximum of 30 business days, absent egregious circumstances. For example, the recommended suspension for filing false Focus Reports[53] and Forms U-4 and U-5[54] is 30 business days. Similarly, the recommended sanction for either failing to report or falsely

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[51] Id. at 53-54.

[52] The NASD Sanction Guidelines direct Adjudicators to consider whether the respondent was disciplined before regulatory detection of the misconduct. See District Bus. Conduct Comm. v. Barbara Robinson Hoganson, No. C8A920095, 1993 NASD Discip. LEXIS 242, at *12 (NBCC Aug. 26, 1993) (In light of mitigating factors, the respondent was credited with the time she was not working in the industry where she was found to have misappropriated customer funds.); Department of Enforcement v. Stephen Earl Prout, No. C01990014 **,** 2000 NASD Discip. LEXIS 18, at *16 (NAC Dec. 18, 2000) (respondent credited with his firm's three-month suspension). Cf. Department of Enforcement v. John Lawson Greer, III, No. C05990035, 2001 NASD Discip. LEXIS 34 (NAC Aug. 6, 2001) (respondent not given credit for his time out of the industry where his time out was attributed to the respondent's conduct and not the result of regulatory action).

[53] Sanction Guidelines 76.

[54] Id. at 77.

reporting an activity under Conduct Rule 3070 is a maximum of 30 business days.[55] In comparison, the Hearing Panel believes that the foregoing violations are more serious than Davenport's misconduct. Each of the foregoing violations involves the non-disclosure of information concerning the fitness or eligibility of an individual to engage in the securities business, whereas Davenport failed to disclose information relating to Hilliard's preferred business practices.[56] On the other hand, Davenport failed to disclose the loans for at least three years. This factor justifies a suspension greater than 30 business days.

On balance, the Hearing Panel finds that no regulatory purpose would be served by imposing a longer suspension. Having had the opportunity to observe Davenport at the hearing, the Hearing Panel concludes that he would not pose a threat to the investing public if he were allowed to return to the industry. None of Davenport's activities was illegal, and he honored his financial obligations until he was fired by Dean Witter. Moreover, the Department concedes that there is no evidence that Davenport took undue advantage of his customers. In addition to the fact that all of the loans were documented properly with legally enforceable promissory notes, there is no evidence of overreaching by Davenport, such as churning or unauthorized trading in their accounts. Indeed, the evidence shows that Davenport followed a relatively conservative course with his customers. Accordingly, the Hearing Panel finds no reason to prohibit Davenport from returning to the securities business at this time.

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[55] Id. at 82. Among other things, Conduct Rule 3070 requires members to report to the NASD whenever the member or a person associated with the member is found to have violated the securities laws or is alleged to have engaged in certain illegal activity.

[56] The Hearing Panel does not mean to suggest that Hilliard's policy was not important.

With respect to payment of the fine, the Hearing Panel agrees with the Department's suggestion that immediate payment would divert money otherwise available for repayment of customer loans. Accordingly, the Hearing Panel will direct the Department and Davenport to arrive at an installment payment plan once he becomes associated with a member firm. The plan shall take into account his payment obligations on the customer loans and shall require that he remain current on his payments to his former customers.

IV. ORDER

Having considered all of the evidence,[57] the Hearing Panel orders as follows:

1) James S. Davenport is suspended from association with any NASD member firm in any capacity for nine months. However, Davenport is credited with the time he has not been working in the industry, thus his suspension has been served.

2) James S. Davenport is fined $10,000, which fine shall be payable in accordance with the terms of an installment payment plan to be agreed upon by the Department and Davenport if he re-enters the securities industry. Unless the Department extends the time, the Department and Davenport shall arrive at an installment payment plan once he becomes associated with a member firm. The installment plan shall take into account his payment obligations on the customer loans and shall require that Davenport periodically report to the Department regarding the status of the loans. Should Davenport default on his loan payments, the Department may accelerate the balance due on the fine.

[57] 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.

3) James S. Davenport is barred from opening a leveraged trading account with any firm with which he associates until he has repaid all of the customer loans in full and paid the fine.

The foregoing sanctions shall become effective on a date set by the NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of the NASD.

Davenport also is ordered to pay costs in the total amount of $1,110.42, which include an administrative fee of $750 and hearing transcript costs of $360.42.

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Andrew H. Perkins
Hearing Officer
For the Hearing Panel

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