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NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondents.	Disciplinary Proceeding No. C8A990015 Hearing Officer—Andrew H. Perkins **Hearing Panel Decision** November 18, 1999

Digest

The Department of Enforcement filed a Complaint alleging that Respondent _____ (_____) violated the NASD's Free Riding and Withholding Interpretation (IM-2110-1) and NASD Conduct Rule 2110 by selling hot issues to three restricted accounts. The Department of Enforcement

also charged Respondent _____ with failing to supervise _____ reasonably in violation of NASD Conduct Rules 2110 and 3010. Based on the evidence admitted at the hearing, the Hearing Panel determined that _____ violated Conduct Rule 2110 by selling hot issues to one account, but the Hearing Panel found that _____ had not failed to supervise _____ reasonably. Accordingly, the Hearing Panel dismissed the charges against _____, and, taking into consideration the significant mitigating factors present in this case, determined that the appropriate sanction against _____ was a letter of caution.

Appearances

Mark A. Koerner, Senior Regional Counsel, Chicago, Illinois, and Rory C. Flynn, Chief Litigation Counsel, Washington, DC, counsel for the Department of Enforcement.

_____ and _____ of _____, Chicago, Illinois, counsel for _____.

_____ and _____ of _____, Boston, Massachusetts; and _____ of _____, New York, New York, counsel for _____ _____.

DECISION

I. Introduction

On February 8, 1999, the Department of Enforcement (Enforcement) filed the Complaint in this disciplinary proceeding. The Complaint contains two causes. The first alleges that _____ (_____), a General Securities Representative at _____ (_____), sold 29 public offering

stocks that immediately traded at a premium in the secondary market ("hot issues") to three restricted accounts in violation of NASD Conduct Rule 2110 and NASD Conduct Rule Interpretation IM-2110-1 pertaining to free-riding and withholding ("Free-Riding and Withholding Interpretation" or the "Interpretation"). According to the First Cause of the Complaint, between September 1993 and April 1996, _____ sold 22 hot issues to _____, seven hot issues to the account of A.W. and B.W., and four hot issues to the account of J.W. and S.W. The Complaint further alleges that _____, J.W., and S.W. were registered with the Securities and Exchange Commission ("SEC") as broker-dealers and that A.W. was associated with a broker-dealer that was registered with the SEC. The Second Cause of the Complaint alleges that _____ (_____), the manager of _____ Chicago Mega Branch Office from September 1993 through July 1995, failed to enforce _____ supervisory procedures and failed to exercise reasonable supervision of _____ in violation of NASD Conduct Rules 2110 and 3010. The Complaint further alleges that _____ failed to prevent _____ from effecting the sales of hot issues to _____ during the time that _____ was the branch manager of _____ Chicago Mega Branch Office.

A hearing was held in Chicago, Illinois, on August 31 and September 1, 1999. Enforcement called five witnesses, including the Respondents, and introduced 77 exhibits into evidence. _____ testified on his own behalf and introduced 30 exhibits into evidence. _____ called an expert witness,

O. Ray Vass, and introduced 33 exhibits into evidence. In addition, the Parties introduced 10 joint exhibits, and they filed an Agreed Stipulations Of Facts dated August 6, 1999.[1]

Enforcement requests that the Respondents be fined less than $10,000 each and that _____ be suspended for a few days in his principal capacity.

II. Findings of Fact

A. Respondents

1. _____

_____ has worked in the securities industry for more than 42 years. He first entered the profession in February 1957 when he joined Goodbody & Company as a General Securities Representative. (Tr. Vol. I, at 104.) Thereafter, he worked at a series of firms until July 1986 when he joined _____ (_____), which later merged with _____. (Ex. C-1, at 1.) _____ is currently employed by _____ in its Chicago Mega Branch Office as a General Securities Representative.

_____ career is free of any disciplinary action. Indeed, over the course of the 42 years he has worked as a securities professional, he has never been the subject of either a customer or formal complaint, apart from the instant proceeding. (Tr. Vol. II, at 6.)

[1] Reference to the hearing transcript are cited as "Tr. Vol. __, at ___." Citations to exhibits are as follows: Enforcement's are noted as "Ex. C-___"; _____ are noted as "Ex. K-___"; _____ are noted as "Ex. D-___"; and the Parties joint exhibits are noted as "Ex. J-___."

2. **_____**

_____ is presently employed by _____ where he is the National Director of _____ Private Client Services Division. (Stip. ¶ 5.) He is registered as a General Securities Representative and a General Securities Principal.

_____ began his career in the securities industry with Merrill, Lynch, Pierce, Fenner & Smith, Inc. in October 1974. (Ex. C-2, at 1.) He joined _____ in September 1975 and worked there until November 1981. While working for _____ he attended law school and obtained his law degree in June 1981. (Ex. C-2, at 15.) From October 1981 through February 1996, _____ worked for _____, which through a series of mergers and acquisitions became _____.

_____ has held four branch management positions over his career. He first managed _____ Chestnut Hill, Massachusetts branch office from approximately November 1981 through December 1982. Then, from December 1982 through January 1987, he managed _____ Boston branch office. In approximately January 1987, he was appointed to manage _____ Chicago branch office that became _____ Chicago Mega Branch Office. Finally, from February 1996 through January 1999, _____ managed _____- Chicago branch office. (Stip. ¶ 6.)

_____ has never before been subject to disciplinary proceedings, and he has never been found liable for a customer complaint. (Ex. C-2; Stip. ¶ 7.)

B. The Chicago Mega Branch Office

During _____ tenure with _____, the Chicago Mega Branch Office grew to become the firm's largest retail branch with 125 registered representatives and a 75 person support staff. (Tr. Vol. I, at 299.) The Chicago office was twice as large as the next largest _____ branch office. By the time he left, the branch had approximately 50,000 accounts and annual sales of $55 million. (Tr. Vol. I, at 300.) Typically, the branch processed nearly 1000 completed orders a day. (Id.) In addition, two satellite branch offices reported to _____.

1. The Supervisory Structure of the Chicago Mega Branch Office

Due to its large size, the Chicago Mega Branch Office was designed and implemented to mirror a regional operation. (Tr. Vol. I, at 301.) Under _____ direction, management functions were organized according to each of the major operating areas of the branch, including compliance, administration, sales, and operations. Each area was headed by a securities professional with a Series 8 license, and each of those managers reported directly to _____. (Id. at 301-03.)

A central component of the supervisory structure for the Chicago Mega Branch Office was the implementation of the Control Administrator function. The Control Administrator was designed to be a full time, professional compliance officer for the branch. Shortly after _____ appointment as branch manager, he hired _____ as the branch's Control Administrator. (Tr. Vol. I, at 146.) At the time he was hired, _____ had more than 14 years experience as a compliance professional, including more than six years with the Chicago Board Options Exchange ("CBOE") where he was a Senior Sales Practice Examiner. (Tr. Vol. I, at 189, 316; Tr. Vol. II, at 45-46.)

In his role as Control Administrator, Mr. _____ assumed many of the branch's compliance and supervisory responsibilities. These included registration, insurance, active account reviews, new account and option approvals, and compliance inquiries. (Tr. Vol. I, at 146-47; Ex. C-32.) Significantly, Mr. _____ responsibilities also included review of the distribution of syndicate issues to clients of the Chicago Mega Branch Office. (Tr. Vol. I, at 278-79.) Mr. _____ was second in command of the Chicago office and was responsible for the branch in _____ absence. (Id. at 301.) This authority and responsibility was formally delegated to and accepted by Mr. _____ in writing. (Ex. K-5.)

2. The Branch's Syndicate Procedures

_____ had an established set of procedures for the distribution of new issues to brokers. In the first instance, _____ relied upon the brokers to guard against potential free-riding and withholding violations. The system relied upon the brokers' knowledge of their customers to ensure that restricted accounts did not receive shares of hot issues. _____ written procedures informed brokers of the various categories of accounts that were considered "restricted" by the NASD and made clear that such accounts could not receive shares of hot issues. (Ex. D-25.)

Additionally, at the branch level, _____ implemented several measures in the syndicate allocation process to guard against potential violations. _____ designated the initial responsibility for the allocation of new issues to _____. Mr. _____ served as the "Branch Syndicate Coordinator" and interacted with _____ regional coordinators and the Corporate Syndicate Department. Mr. _____ reported both to _____, with respect to sales and marketing issues, and Mr. _____, with respect to compliance issues. (Tr. Vol. I, at 246.)

When a new issue was offered to the sales force, _____ system required the Branch Syndicate Coordinator to obtain "indications of interest" from the brokers in the office. (Id. at 247-48.) If a particular offering was later determined to be a "hot issue," _____'s Corporate Syndicate Department was to alert the branches by wire, and the branch was required to determine whether any orders had been entered for restricted accounts. (Id. at 151; Ex. D-9.) If so, the branch was required to return any shares allocated to restricted accounts to the Syndicate Department for reallocation.

_____ used a specific form to document certain information regarding the accounts that received shares of a new syndicate offering. This form was known internally as Form 3602. Among the information called for by Form 3602 was verification that any participating broker-dealers were purchasing the new issues for their customers and not for their own accounts. (Ex. C-14, at 7.)

At the Chicago Mega Branch Office, Mr. _____ was assigned the task of completing this form for each new issue. _____ also assigned Mr. _____ the task of reviewing, approving, and signing off on each completed Form 3602. _____ established this two-level process to assure that there would be no violations of the NASD's free-riding and withholding rules. Mr. _____ testified however that he delegated this function to his assistant and never reviewed her work. (Tr. Vol. I, at 253-54.) According to Mr. _____, although he signed every Form 3602, he did not consider their content to be anything about which he should be concerned. (Id. at 254.) And Mr. _____ testified that although he signed the completed forms, he relied completely on Mr. _____ to assure that the information was accurate. (Id. at 154.) Thus, the system broke down. In actuality, there was little, if any, review for compliance with the

free-riding and withholding rules. _____ was unaware that the process he had established was not effectively being followed.

C. _____ Account

_____ is a privately owned securities specialist firm and a member of the Chicago Stock Exchange (formerly the Midwest Stock Exchange). (Id. at 111-12.) _____ is registered with the SEC as a broker-dealer but has never been a member of the National Association of Securities Dealers, Inc. ("NASD"). (Tr. Vol. I, at 49; Tr. Vol. II, at 7.) During the time in question, the firm was controlled by _____, who died before the institution of this proceeding.[2]

_____ first opened an account for _____ in 1965, and it was one of _____'s largest customers over the ensuing 30 years. (Tr. Vol. II, at 7.) During that time, _____ worked at six firms before joining _____ in 1986. (Tr. Vol. II, at 6-7.) Between 1993 and 1995, _____ purchased between $1 million and $3 million of securities a year through _____. (Tr. Vol. II, at 13.) This represented a volume of 10,000 to 15,000 shares a day. (Tr. Vol. II, at 13.) In 1995, the _____ account generated $297,000 in gross commissions for _____, of which _____ received approximately $104,000. Sixty percent of the business _____ did through _____ involved syndicate business. (Tr. Vol. II, at 12.)

[2] Unfortunately, Enforcement did not try to interview Mr. _____ before his death. Enforcement also did not try to interview anyone else at _____ before filing the Complaint because the NASD did not have jurisdiction over the firm.

1. Sales of Hot Issues to _____

There is no dispute that _____ sold _____ 22 hot issues between September 1993 and October 1995. (Ex. J-9 and Ex. J-10.) The evidence shows that each of the securities listed in the Joint Exhibits sold at a premium in the immediate aftermarket. Indeed, _____ concedes that he sold hot issues to _____ on a regular basis for the entire period it was his customer. But he maintains that neither he nor his firms were aware that these sales violated the NASD's Free-Riding and Withholding Interpretation. (Tr. Vol. II, at 10-12; Ex. D-24.)

_____ testified that he understood the NASD's Free-Riding and Withholding Interpretation to apply only to broker-dealers that were members of the NASD. (Tr. Vol. II, at 10-11.) He felt that his understanding was accurate inasmuch as there had never been a question about his sale of hot issues to _____ even though the account was audited and reviewed at least annually, and all six times _____ moved from one firm to another he filled out a new account form for the _____ account. (Tr. Vol. II, at 8-9.) None of the firms ever questioned whether _____ should be a restricted account under the NASD's Free-Riding and Withholding Interpretation. (Tr. Vol. II, at 9.)

_____ also believed from his personal relationship with the _____ family that _____ had individual accounts or public customers. (Tr. Vol. I, at 121.) _____ came to the same conclusion after he visited with _____ at his firm. (Tr. Vol. I, at 116, 292.) _____ had arranged the meeting so that _____ could get to know Mr. _____and his operation. _____ and _____ testified that during a tour of _____ Mr. _____referred to his "individual accounts," including his "retail" accounts. _____ further testified that from what Mr. _____said at the meeting, _____

had no doubt that _____ was eligible to purchase hot issues. It was not until the investigation that led to this proceeding was instituted that _____ and _____ learned that their understandings were incorrect.

2. The _____ Audit of the Chicago Mega Branch Office

In November 1994, _____ conducted its first annual audit of the newly acquired Chicago Mega Branch Office. In the course of that audit, the _____ auditors raised the issue that there was missing documentation reflecting that the syndicate allocation issues going to broker-dealers ultimately were being sold to public customers. The auditors first raised this issue with _____, and he set up a meeting with Mr. _____ to review the auditors' preliminary findings. (Tr. Vol. I, at 157-58.) At no time did the auditors suggest that the sale of hot issues to _____ was improper. (Tr. Vol. I, at 290-91.) The issue was treated as a missing documentation problem.

Mr. _____ testified that he and Mr. _____ were caught off guard by the auditors' comments because they had never heard of the requirement for such documentation. (Id. at 158.) Therefore, Mr. _____ requested the auditors send him supporting information for their request. (Id. at 158-59.) The subject of the missing documentation was again addressed at the wrap-up meeting at the conclusion of the audit. Both _____ and Mr. _____ attended this meeting. At the wrap-up meeting Mr. _____ again expressed his surprise that the auditors were looking for this information, and he reiterated his request that the auditors send him some written materials explaining the basis for their request. (Id. at 160, 162.) Mr. _____ wanted clarification on what exactly it was that the auditors wanted. The auditors, however, never supplied the requested information. (Id. at 163.)

Inexplicably, it took the _____ auditors until March 22, 1995, to submit their findings to the Chicago Mega Branch Office. (Ex. D-15.) The report concluded that generally the office was in compliance with _____'s policies and procedures and noted several exceptions. (Id. at 1.) Under the subheading of "Supervision" the report stated: "3. A review of the Syndicate file revealed: . . . (d) Accounts of a registered broker/dealer, received shares of a 'hot issue.' Assurances from the client that bona-fide public customers are receiving the stock are not on file." (Id. at 3.)

3. _____'s Response to the Audit

When _____ received the audit report, he reviewed the report promptly with Mr. _____. Together, they went through each of the exceptions raised in the report. (Tr. Vol. I, at 238.) With respect to the missing assurances regarding hot issues, Mr. _____ explained to _____ that he had requested additional information from the auditors, but he had not yet received any. At that point, _____ instructed Mr. _____ to follow up with Mr. _____ and obtain the needed letter. (Id.)

Mr. _____ testified that he believed that Mr. _____ would contact _____ who in turn would get the letter from _____ although neither Mr. _____ nor _____ assigned Mr. _____ this task. (Tr. Vol. I, at 230-32.) Mr. _____ confirmed that he was not requested to obtain the assurance letter from _____ (Id. at 257.) Mr. _____ recalled that _____ spoke to him about the letter and stated that he was not sure if he should have Mr. _____ or Mr. _____ work with _____ to get the letter from _____ (Id. at 268.) In the end, Mr. _____ said that _____ concluded that Mr. _____ should follow up with _____. (Id.) _____ also testified that he assigned Mr. _____ to get the letter from _____ (Id. at 287-88.)

Under _____'s policies and procedures, _____ was required to sign off on the audit report and indicate that he had rectified the exceptions noted in the audit report. (Ex. J-4.) As part of this process, _____ asked Mr. _____ if all of the missing documents had been secured. Mr. _____ told him that they had, and, relying on this representation, _____ signed off on the audit report. (Tr. Vol. I, at 166-67, 294.) Mr. _____ explained that he told _____ that he could sign the form because he believed all of the documents had been obtained after asking Mr. _____ for an assurance that the necessary letter could be obtained from _____ (Id. at 195, 232.)

In June 1995, _____ conducted the next annual audit of the Chicago Mega Branch Office. The report from that audit did not disclose missing documentation for the _____ account. (Tr. Vol. I, at 295.) In fact, it was not until months later, after _____ left _____, that the _____ account was again questioned. _____ did not learn that Mr. _____ had failed to get the letter from _____ until after _____ left _____.

4. _____'s Reporting of Free-Riding and Withholding Violations to the NASD

In late 1995, _____'s compliance department in New York started an inquiry about the _____ account. (Tr. Vol. I, at 168.) This inquiry uncovered free-riding and withholding violations. Upon their discovery, _____ requested a meeting with the NASD. At the meeting on December 22, 1995, _____ presented the NASD with a schedule of the hot issues that _____ had sold to _____ and a chart showing that only 1.4% of the new issues sold to _____ were hot issues. (Tr. Vol. I, at 65; Ex. D-13.) On December 27, 1995, _____ sent the NASD a revised spreadsheet of hot issues sold to _____ between September 15, 1993,

and October 10, 1995. (Ex. D-12.) This spreadsheet listed the 22 hot issues that are the subject of this proceeding and reflected that the total commissions received on these transactions was $12,868. (Ex. D-12.) _____ earned about $4,500 of the total commissions. (Tr. Vol. II, at 18.)

After receiving this information from _____, the NASD initiated an investigation of those specific transactions. In mid-1996, the NASD expanded the scope of its investigation after _____ informed the NASD of additional sales of hot issues to restricted accounts, including transactions in another branch office. (Tr. Vol. I, at 98.) This investigation led to the filing of the Complaint in this disciplinary proceeding. The NASD also charged Mr. _____ and _____ with failing to supervise _____ adequately. Both Mr. _____ and _____ settled the charges against them by entering into a Letters of Acceptance, Waiver and Consent ("AWC"). Mr. _____ consented to a censure and a $5,000 fine,[3] and _____ consented to a censure and a $15,000 fine. (Ex. D-20; Ex. D-22.)

D. The A.W. and B.W. Account

In October 1995, _____ opened an account for A.W.[4] (Tr. Vol. I, at 124; Ex. K-12.) At the time, A.W. was 69 years old, retired, very ill, and living in Florida. He had been a trader before he retired, but he was not registered with any exchange at the time he opened the account. He did,

[3] The AWC states in pertinent part:

From in or about February 1995 through in or about February 1996, [_____], acting through _____, failed to enforce written supervisory procedures and failed to adequately and properly supervise [_____], in that _____ failed to prevent [_____] from making numerous sales of Hot Issues to the accounts of _____, J.W./S.W. and A.W./B.W., . . . when such accounts were restricted from purchasing Hot Issues under IM-2110-1. The acts, practices and conduct set forth herein constitute separate and distinct violations of NASD Conduct Rules 2110 and 3010 by _____.

[4] The account was opened as a joint account with B.W., A.W.'s wife.

however, own a company, A.D.W. Corporation ("ADW"), which is a broker-dealer registered with the SEC, but ADW was not engaged in the business of buying and selling securities for the accounts of others. (Id. at 51, 181.) ADW's business was limited to leasing a seat on the New York Stock Exchange and one on the CBOE. (Tr. Vol. I, 180-81.) ADW's only income was the rental it received from those leases.

Between January and April 1996, _____ sold seven hot issues to A.W., which are listed on Joint Exhibit 10. The magnitude of these sales was limited. The securities were sold in lots of between 50 and 300 shares each, and the largest purchase was for $5,700. In total, A.W. purchased 1050 shares at a cost of $17,100.

E. The J.W. and S.W. Account

In September 1995, _____ opened an account for J.W. (Tr. Vol. I, at 128; Ex. K-11.) J.W. had been registered previously as a broker-dealer with the SEC, but he was not either a broker or a dealer when the account was opened or when _____ sold him four hot issues, which are listed on Joint Exhibit 10.[5] The four purchases involved only 500 shares at a total cost of $8,150.

J.W.'s registration ended in July 1995. (Ex. C-8.)

In November 1995, J.W. added his friend, S.W., to the account. S.W. was registered with the SEC as a broker-dealer, and he had been an options trader. At the time he was added to the account, however, he was completely out of the securities business, in bad health, and suffering from drug

[5] The Complaint charged that J.W. was registered with the SEC as a broker-dealer when the hot issues were purchased. Enforcement changed its theory at the hearing, conceding that J.W. was not registered at the time. The hot issues are listed in Joint Exhibit 10.

problems.[6] (Tr. Vol. I, at 130.) J.W. and S.W. told _____ that S.W. was no longer operating as broker-dealer. Accordingly, _____ did not consider the account restricted. They also told _____ that S.W. was being added to the account as an "accommodation," not to give him an ownership interest in the account. (Tr. Vol. II, at 16.) _____ understood that S.W. had no authority to trade in the account and _____ treated the account as such although the new account form reflected that S.W. was added as a joint owner. (Id.) There is no evidence that S.W. ever conducted any business in the account.

F. _____'s Discipline of _____

_____ took strong disciplinary action against _____. First, _____ took back all of the commissions it had paid _____ on the alleged violative transactions. (Tr. Vol. II, at 18.) Second, _____ took back all commissions _____ had earned on the sale of new issues in all of his other accounts for a period of 18 months without regard to whether they were hot issues or whether their sale violated any rules or regulations. (Tr. Vol. II, at 19.) The forfeiture of these commissions amounted to an estimated loss to _____ of $100,000. Third, _____ restricted _____ from selling new issues to any customers until May 1997. _____ estimates that he lost another $100,000 as a result of this restriction. (Tr. Vol. II, at 20-21.) Although _____ continued to work on these other accounts, _____ kept what otherwise would have been his share of the earned commissions.

[6] J.W. had been listed to testify, but at the scheduled time _____'s counsel represented that J.W. was too impaired to do so. S.W. also did not testify. He died in 1997. Unfortunately, Enforcement did not interview him before he died.

III. Conclusions of Law

A. Jurisdiction

The NASD has jurisdiction of this proceeding. _____ and _____ were registered with the NASD at the time of the alleged violations and at the time Enforcement filed the Complaint.

B. Free-Riding and Withholding—Cause One

The NASD's Free-Riding and Withholding Interpretation (Ex. C-11) ensures that NASD members and their associated persons make bona-fide distributions to the public of securities that are part of a public offering.[7] The Interpretation provides that it is a violation of Conduct Rule 2110 to fail to make a bona-fide distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins. The Interpretation specifically provides that it is a violation of Conduct Rule 2110 for a member or person associated with a member to sell any such securities to a person associated with a broker-dealer or to a another broker-dealer unless the selling broker-dealer first receives a written assurance from the purchasing broker-dealer "that such purchase would be made to fill orders for bona fide public customers . . . at the public offering price as an accommodation to them and without compensation for such." The Interpretation is designed to prevent restrictions on the supply of offerings that trade at an immediate aftermarket premium.[8]

[7] In re John W. Crute, Exchange Act Release No. 40474, 1998 SEC LEXIS 2035, at *14 (Sept. 24, 1998).

[8] In re First Philadelphia Corp., 50 S.E.C. 360, 361 (1990).

Because the Interpretation is prophylactic in nature, it does not require proof of scienter to support a finding of violation.[9] Violations of the Interpretation need not be intentional, even an inadvertent violation is sufficient to find a violation of Conduct Rule 2110. The respondent's state of knowledge and intent are, however, relevant in determining sanctions.[10]

1. The _____ Account

With respect to the _____ account, there is no dispute that it was a restricted account and that the 22 securities identified in Joint Exhibits 9 and 10 that _____ sold to _____ were hot issues. _____ also conceded at the hearing that _____ had no public customers, and it therefore could not have qualified to receive hot issues under the NASD's Free-Riding and Withholding Interpretation. Moreover, it is undisputed that the Interpretation applies to broker-dealers which are not NASD members.[11] Accordingly, the Hearing Panel finds that _____ violated IM-2110-1 and Conduct Rule 2110 by selling 22 hot issues to _____, as alleged in the Complaint.

The Hearing Panel also finds however that _____'s violation was inadvertent. The Hearing Panel credits his testimony that he was unaware that the _____ account should have been restricted from receiving hot issues. Although ignorance of the NASD rules is not a defense, the history of the account is a consideration for sanctions.[12] _____ had a long-standing relationship with _____, and despite numerous audits and reviews of its account, its restricted status was never

[9] Id. at 361-62.

[10] See, e.g., Crute, at 1998 SEC LEXIS *14.

[11] See In re Equity Sec. Trading Co., Inc., Exchange Act Release No. 39520, 1998 SEC LEXIS 18 (Jan. 7, 1998).

[12] Id. at 1998 SEC LEXIS *17 (fact that violation resulted from ignorance and inadvertence considered mitigating by the NASD).

raised in over 30 years. The failure to accurately identify the _____ account as restricted was not the result of _____'s concealment of the nature of the account. The new account form clearly identified _____ as a member of the Midwest Stock Exchange. Rather, for the period relevant to this proceeding, the Hearing Panel specifically finds that the failure to detect that the account should be restricted resulted in large measure from _____'s deficient supervision of _____. The evidence showed that Mr. _____ and Mr. _____ failed to enter and review properly the information on the Form 3602s. And Mr. _____ failed to supervise the brokers at the Chicago Mega Branch Office to ensure compliance with the NASD's Free-Riding and Withholding Interpretation.

2. The A.W. and B.W. Account

The Hearing Panel finds that _____ did not violate the NASD's Free-Riding and Withholding Interpretation by selling hot issues to A.W. because his account was not restricted. A.W. was not himself registered as a broker-dealer, and he was not associated with a broker-dealer as that term is defined by the NASD By-Laws.

Enforcement asserts that A.W. was disqualified from purchasing hot issues because he owns and is associated with ADW, a corporation registered with the SEC as a broker-dealer. While this association normally would be sufficient to restrict A.W. from purchasing hot issues, it is insufficient in this case because ADW does not engage in the securities business. Its sole business activity is the collection of rent for the two exchange seats it owns. ADW conducts no business with the public and effects no trades on behalf of others.

The NASD's Free-Riding and Withholding Interpretation applies to broker-dealers, but the interpretation does not define the term broker-dealer. Therefore, the Hearing Panel must look to the definition of broker-dealer contained in the NASD's By-Laws. Sub-section I(e) of the NASD's By-Laws defines "broker" as:

> [a]ny individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization, or other legal entity **engaged in the business of effecting transactions in securities for the account of others**, but does not include a bank. (Emphasis added.)

Similarly, sub-section I(h) of the NASD's By-Laws defines "dealer" as:

> [a]ny individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization, or other legal entity **engaged in the business of buying and selling securities for such individual's or entity's own account, through a broker or otherwise, but does not include a bank, or any person insofar as such person buys or sells securities for such person's own account, either individually or in some fiduciary capacity, but not as part of a regular business**. (Emphasis added.)

In other contexts, the courts have held that to be "engaged in the business" of buying and selling securities, and therefore to be a broker or dealer, there must be an actual "regularity of participation" in effecting purchases and sales of securities.[13] Such participation in the market is not present here. Accordingly, ADW does not fall within the traditionally accepted definition of a broker-dealer.

Application of this definition to the NASD's Free-Riding and Withholding Interpretation is also consistent with its regulatory purpose. In essence, the proper inquiry is whether A.W. is a member of the public for the purposes of application of the Interpretation, or is he associated with an industry

member so that the shares sold to him can be said to have been withheld from purchase by members of the public. The Hearing Panel concludes that A.W.'s association with a company that is not participating at all in the securities business, although registered, is not a violation of the spirit or the letter of the Interpretation. The evidence clearly shows that A.W. was investing for his own account, as any other public customer, and ADW was dormant. Accordingly, the Hearing Panel dismisses the charge that _____ violated Conduct Rule 2110 by selling hot issues to A.W.

3. The J.W. and S.W. Account

The Hearing Panel likewise finds no violation in _____'s sale of hot issues to J.W. because his account also was not restricted. The Hearing Panel credits _____'s testimony that S.W. was not at all involved in the securities business during the time he was on J.W.'s account. He certainly was not operating as a broker-dealer despite the fact that he was still registered with the SEC. Thus, the Hearing Panel concludes that S.W. was not a broker-dealer for the purposes of the NASD's Free-Riding and Withholding Interpretation. As with the previous account, there is no evidence that S.W. was actively engaged in the securities business.

The Hearing Panel also credits _____'s testimony that S.W. was added to the J.W.'s account to help S.W., not to give him an ownership interest in the account. J.W. wanted to be able to help his friend who had formerly been in the industry but had fallen on hard times due to health and drug problems. _____ testified that he understood that S.W. did not have an ownership interest in the

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[13] See, e.g., Massachusetts Fin. Servs., Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), aff'd, 545 F.2d 754 (1st Cir. 1976); SEC v. Hansen, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,426 (S.D.N.Y., 1984).

account and did not have authority to buy or sell securities in the account. Other than the new account form, Enforcement presented no evidence to suggest otherwise. Likewise there is no evidence that S.W. ever took any action with respect to the account.

With respect to the new account form, the Hearing Panel concludes that the account was mistakenly opened with the "joint account" designation.[14] The Hearing Panel finds that J.W. and S.W. had not intended to grant to S.W. an ownership interest in the account, and there is no evidence showing that S.W. ever exercised any ownership rights over the account. Accordingly, under the unique facts of this case, the Hearing Panel concludes that Enforcement has failed to prove by a preponderance of the evidence that S.W. had a sufficient beneficial interest in the account to make it a restricted account under the NASD's Free-Riding and Withholding Interpretation.

For the foregoing reasons, the Hearing Panel dismisses the charge that _____ violated Conduct Rule 2110 by selling four hot issues to J.W.

C. Supervision—Cause Two

There is no evidence that _____ failed reasonably to supervise _____. Accordingly, the Hearing Panel dismisses the charges against _____.

NASD Conduct Rule 3010 requires member firms to establish a supervisory system reasonably designed to achieve compliance with applicable laws, rules and regulations. The Rule further requires that, as a component of the supervisory system, a member establish and maintain written supervisory procedures to supervise the types of business in which it engages and to supervise the activities of

registered representatives and associated persons that are reasonably designed to achieve compliance with applicable laws, rules and regulations.

Conduct Rule 3010 does not, however, impose strict liability on supervisors for the misdeeds of their subordinates. Where a manager or other person with overarching supervisory responsibility reasonably delegates particular functions to another, the delegating manager may only be found to have failed to supervise reasonably when the delegating manager knows or has reason to know that the performance of the person to whom the function is delegated is deficient.[15] Indeed, delegation of supervisory responsibility is an important element of broker-dealers' supervisory systems where there are large numbers of employees.

Here, Enforcement has not shown or suggested that _____ unreasonably delegated to Mr. _____ the responsibility for reviewing and approving Mr. _____'s completion of the syndicate new issue forms (*i.e.* the Form 3602s). Enforcement also has not shown or suggested that _____ was aware of any deficiency on Mr. _____'s part before the November 1994 audit. Likewise, with respect to the post-audit period, Enforcement has not shown that _____ acted unreasonably. The Hearing Panel finds that _____ appropriately assigned Mr. _____ the task of obtaining the assurance letter from _____ _____ also followed up with Mr. _____ to ensure that the issue was addressed, and he was ultimately told by Mr. _____ that the letter had been obtained.

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[14] The Hearing Panel also notes that the new account form does not have a classification that would appear to meet J.W's intention.

[15] See, e.g., In re Patricia Ann Bellows, SEC Initial Decision No. 128, 67 S.E.C. Docket 1426, 1430, 1998 SEC LEXIS 1521, at *21 (July 23, 1998).

Under these facts, the Hearing Panel finds that _____ reasonably delegated responsibility for monitoring compliance with the NASD's free-riding and withholding rules, and there were no red flags indicating that he should more closely review the branch's procedures in general or the _____ account in particular. Thus, the Hearing Panel dismisses the charges against _____.

IV. Sanctions

The overall purposes in imposing sanctions are to remediate misconduct and to protect the investing public.[16] To these ends, Hearing Panels are instructed to tailor sanctions to the misconduct in each particular case.[17]

Guided by these principles, the Hearing Panel concludes that the appropriate remedial sanction for _____ is a Letter of Caution. This sanction is below the guideline for free-riding and withholding violations, which calls for a minimum fine of $1000.[18] The Hearing Panel believes this deviation from the suggested sanction is appropriate for several reasons.[19]

First, _____'s violation was inadvertent. The Hearing Panel credits his testimony that he believed that the NASD's Free-Riding and Withholding Interpretation did not apply to the _____ account because _____ is a specialist firm. There was no evidence to suggest that the issue of _____ purchasing hot issues had ever been raised despite the fact that for 30 years it had been a

[16] NASD Sanction Guidelines 3 (2d ed. 1998).

[17] Id. at 4.

[18] Id. at 22.

[19] The Hearing Panel considered each of the principal considerations for free-riding and withholding (NASD Sanction Guidelines 22), the general principles applicable to all sanctions determinations (Id. at 3-7), and the principal considerations that adjudicators always should consider (Id. at 8-9).

very active account at each of the six firms with which _____ had been associated. By the time _____ joined _____ in 1986, there was no reason for him to question the propriety of his activity. Every firm at which he had been employed had reviewed the account, but not restricted it. Although this history does not constitute a defense to the charge, it substantially mitigates the seriousness of the violation and the need for a monetary sanction.[20] The Hearing Panel also notes that once the violation was brought to _____'s attention he immediately acknowledged his mistake and assured his firm and the NASD that it would not happen again. _____ also fully cooperated at all stages of the investigations conducted by _____ and NASD Regulation.

Second, _____ did not conceal the nature of the _____ account. At each firm _____ joined, he accurately disclosed that _____ was a member of the Midwest Stock Exchange. And, when _____ acquired _____, _____ encouraged _____ to visit the firm and meet _____because _____ was one of _____'s largest and most important clients. When _____ did visit _____, he remained of the opinion that _____ was not restricted from purchasing hot issues.

Third, the Hearing Panel believes that the continuing violations resulted from supervisory failures at _____.[21] Although _____ had established a two-tier review process for the allocation of new issues, neither of the responsible persons executed his responsibilities. Mr. _____ completely

[20] See District Bus. Conduct Comm. for Dist. No. 5 v. John W. Crute, Complaint No. C05950018, 1997 NASD Discip. LEXIS 51, at 13 (NBCC Aug. 28, 1997), aff'd, In re John W. Crute, Exchange Act Release No. 40474, 1998 SEC LEXIS 2035 (Sept. 24, 1998).

[21] Cf. District Bus. Conduct Comm. No. 4 v. Equity Sec. Trading Co., Inc., Complaint No. C04940053, 1996 NASD Discip. LEXIS 42, at *21 (Oct. 23, 1996) (lack of supervision considered a mitigating factor).

abdicated all responsibility to his administrative assistant and, in effect, approved the validity of documents he did not review. And Mr. _____, the branch compliance officer, relied on Mr. _____. This left a void where there should have been two layers of review for compliance with the NASD's Free-Riding and Withholding Interpretation.

Fourth, the applicable sanction guideline directs that the Hearing Panel consider whether the account was absolutely or conditionally restricted. The _____ account was conditionally restricted. The firm could under some limited circumstances purchase hot issues as an accommodation to its public customers if it had any. Although _____ did not fall within this proviso, it is nevertheless a significant factor when considering _____'s claim that he mistakenly believed _____ could purchase hot issues.

Fifth, _____ did not have an interest in the _____ account, and he did not establish the account for the purpose of selling hot issues. In fact, over the applicable review period, hot issues comprised less than 1.5% of the sales of new issues to _____. The purchase of hot issues was incidental to the business _____ did with _____.

Sixth, the Hearing Panel also was impressed with _____'s sincerity and forthrightness in addressing the charges against him. The Hearing Panel believes that there is no likelihood that _____ would again violate the Free-Riding and Withholding Interpretation. Accordingly, a sanction greater that a Letter of Caution is unnecessary.

It is also unnecessary to add a monetary sanction because _____ already has been disciplined severely by _____. By _____'s estimate, he lost more than $200,000 due to his suspension

from selling new issues, and he was required to forfeit all of the commissions he earned on the questioned sales.

V. Order

Therefore, the Hearing Panel finds that a Letter of Caution will satisfy the NASD's remedial goals under the particular circumstances of this case. Accordingly, the Hearing Panel orders that this Decision shall constitute a Letter of Caution to _____.

_____
Andrew H. Perkins
Hearing Officer
For the Hearing Panel