NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C05000021
v.	:	
	:	**Hearing Panel Decision**
CHARLES K. WADDELL (CRD #2347936),	:	Hearing Officer - GAC
Oklahoma City, Oklahoma	:	
Respondent.	:	May 14, 2001

Registered representative made untrue statements of material fact to a customer in connection with a sale of securities, effected an unauthorized transfer of customer assets, and engaged in a private securities transaction. Respondent was found liable for violation of NASD Conduct Rules 2110, 2120, and 3040, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder. Respondent was suspended from associating with any NASD member firm in any capacity for two years, fined $40,000, ordered to pay $100,000 in restitution and ordered to receive special supervision in any future association with an NASD member firm.

Appearances

Mark P. Dauer, Esq. and Ralph J. Veth, Esq. (Rory C. Flynn, Washington, DC, Of Counsel), on behalf of the Department of Enforcement.

James U. White, Jr., Esq., on behalf of Charles K. Waddell.

DECISION

I. PROCEDURAL BACKGROUND

A. Complaint

Enforcement filed a three cause Complaint on April 25, 2000, charging that Respondent violated: (1) NASD Conduct Rules 2110 and 2120, Section 10(b) of the Exchange Act, and SEC Rule 10b-5 thereunder, by making untrue statements of material fact to customer AM in connection with a sale of securities; (2) NASD Conduct Rule 2110, by making an unauthorized transfer of customer AM's assets; and (3) NASD Conduct Rules 2110 and 3040, by engaging in a private securities transaction.

B. Answer

Respondent Waddell filed an Answer on June 2, 2000, denying that his actions constituted violations as alleged in the Complaint. With regard to the first cause, Respondent stated that he received information about the security from various sources and simply passed that information along to customer AM. For the second cause, Respondent admitted that he forwarded a Financial Guarantee Bond for the benefit of AM to an individual outside the firm as alleged, but denied that it was without the customer's authorization.[1] Finally, Respondent claimed that the member firm with which he was registered, Dean Witter Reynolds, Inc. ("Dean Witter"), was fully aware of his alleged private securities activities.

C. The Hearing

The Hearing was held in Oklahoma City, Oklahoma, on October 17 and 18, 2000, before a Hearing Panel composed of the Hearing Officer and two current members of the District Committee for District No. 5. Enforcement presented four witnesses: AM, a customer

[1] The Financial Guarantee Bond is alternatively referenced in the Hearing record as a Financial *Guaranty* Bond.

of Respondent; William Lacy, manager of the Oklahoma City Dean Witter branch office at the time of the alleged violations; Anthony Cognevich, an NASD Regulation, Inc. ("NASDR") examiner; and Respondent Waddell. In addition to himself, Respondent presented two witnesses: Lucy Herron, Respondent's sales assistant while he was employed at Dean Witter; and David Dollarhyde, manager of the Oklahoma City Dain Rauscher branch office, where Respondent was employed at the time of the Hearing.

The Hearing Officer admitted into evidence all 17 exhibits offered by Enforcement (CX 1-17)[2] and all 90 exhibits offered by Respondent (RX 1-90A).[3] The Parties offered stipulations as to certain underlying relevant facts ("Stipulations") and made Post-Hearing submissions.[4] The Hearing Panel also marked one document during the Hearing as a Panel exhibit and ordered the Parties to produce certain documents that were submitted after the Hearing.[5]

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[2] Hearing Tr., pp. 276-277, 392-393.

[3] Hearing Tr., pp. 490-491.

[4] Stipulation No. 4 was orally amended at the Hearing to reflect an account opening date for AM's account of July 19, 1996, instead of July 10, 1996. Hearing Tr., p. 341.

[5] Specifically, the Hearing Panel requested: (1) copies of Respondent's tax returns for 1996 through 1999; (2) copies of commission runs earned by Respondent during 1996 and 1997, for each customer account; and (3) account statements for April - August 1996, for accounts at Dean Witter in which Allan Hoffman had trading authority. As noted *infra*, Hoffman was associated with the issuer of the subject securities, had a significant role in providing Respondent with information that led to customer AM's investment in the security, and maintained eight accounts at Dean Witter. The Hearing Panel also allowed Respondent to file a statement of financial condition.

II. FACTS

A. Background

Respondent Waddell first became associated with a member firm in 1993.[6] In February 1995, Respondent became associated with Dean Witter in its Oklahoma City, Oklahoma branch office, where he was registered as a General Securities Representative.[7]

The allegations in the Complaint stem from Respondent's involvement in a $500,000 investment by customer AM in the American Investment Global Unit Trust ("AIGUT"). Respondent transacted this business while employed at and using the facilities of Dean Witter, but without the firm's involvement in the transaction. It is during the course of facilitating the transaction that Respondent made material representations regarding the insured nature of the investment, a Financial Guarantee Bond used to secure the investment that was to be held in a collateral account at Dean Witter, and the extent of Dean Witter's involvement in the transaction.

Respondent's sending of the Financial Guarantee Bond to a third party in connection with his attempt to recover the customer's investment formed the basis for the second cause of Complaint. His involvement in this private securities transaction without having provided required written notification to Dean Witter is the basis for the final allegation.

B. Respondent's Introduction to AIGUT

The American Investment Opportunity Co., L.L.C. ("AIOC"), an entity formed in May 1995 to raise funds for investment in asset-backed securities, developed AIGUT as an

[6] CX 11, p. 2.

[7] CX 11; Stipulations, ¶ 2.

investment vehicle.[8] AIGUT, was a trust "set up as an asset protection trust .... [meaning] that the trust can only acquire assets which are insured by insurance companies with a minimum rating of Single A or better."[9] The security was described in an offering circular as providing "a minimum guarantee of ten percent (10%) income to the investor" and was "available only to Non-United States residents."[10]

Respondent was first introduced to AIGUT in early 1996 by Steve Jernigan, "a local oil man" whom Respondent knew socially through his wife.[11] Jernigan helped form AIGUT and was the Managing Director of Nevis Trust Limited International, the trustee for AIGUT.[12]

In 1996, Jernigan introduced Respondent to Allan Hoffman, the Managing Director of AIOC.[13] Between 1996 and 1997, Hoffman opened eight accounts at Dean Witter with Respondent as the account executive.[14] During 1996 and 1997, the commissions generated by Hoffman's accounts represented approximately 58 percent of the total gross commissions earned by Respondent in those years.[15]

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[8] RX 5. AIOC filed its articles of organization with the Island of Nevis, Office of the Registrar of Companies. RX 7.

[9] RX 4, p. 10.

[10] RX 3, pp. 1-2.

[11] Hearing Tr., pp. 280, 394.

[12] Hearing Tr., pp. 280-281; RX 4, p. 9.

[13] RX 8, p. 1; RX 4, p. 9.

[14] Hearing Tr., pp. 281-282; Complainant's Post-Hearing submission letter dated October 20, 2000, from Anthony M. Cognevich, Special Investigator, NASDR, to Anne Tennant Cooney, Vice President, Sr. Attorney, Morgan Stanley Dean Witter.

[15] Post-Hearing submission by Enforcement of an "NASD Staff Prepared Summary Schedule."

C. Respondent's Initial Involvement in the Sale of AIGUT

Hoffman arranged for Respondent to open two accounts for European investors to invest in AIGUT. The first, TFA, was owned by PB and CM. In addition to being an investor in AIGUT, PB was listed in AIGUT documents as its representative.[16] PB and CM were the original source of information about AIGUT for Respondent's second customer, AM. Information regarding AIGUT that Respondent provided to PB and CM was passed on to AM and formed part of the basis for AM's investment in AIGUT.

D. Respondent's Representations to PB and CM

Based on initial contacts with Hoffman, on June 27, 1996, Respondent sent CM a letter on Dean Witter letterhead explaining a "collateral account that we will administer for the AIOC Unit Trust."[17] The letter, signed by Respondent as "Associate Vice President, Investments," further instructed:[18]

> This account will have deposited in cash or securities an amount equal to 110% of any investments that require this coverage….
>
> This account will be subject to a permanent set of instructions .... These instructions will direct me to act on the notice of 60 days (notification process in the unit trust agreement) that would be sent by the investor to AIOC who will then notify me or [sic] the client's withdrawal or contribution in the trust.
>
> These assets that are held in this account are not part of any moneys of the unit trust. They are separate and totally apart from the investment. They are supplied to guarantee the investment and 10% return on the investment for a twelve month period. If for any reason there is a shortage of money from the investment at the time of the client's withdrawal, the assets will be sold to honor the guarantee that is given by AIOC to the investor.

[16] RX 4, p. 11.
[17] CX 2; RX 10.

[18] Stipulations ¶ 3. CX 2; RX 10.

On July 15, 1996, PB sent Respondent a letter authorizing him to transfer $1,000,000 of TFA funds for investment in AIGUT.[19]

E. Customer AM's Interest in AIGUT

In 1996, AM, a 66 year-old dentist residing in Austria, contacted PB regarding an investment matter. AM informed PB that he had received a cash payout of a life insurance policy and was looking for an investment opportunity for those assets that would pay more than the one or two percent return that was available on investments in Austria. PB told AM that there was a way to invest his money and get at least a ten percent return on his investment.[20]

PB discussed with AM the possibility of investing his money in AIGUT. PB outlined the manner in which the investment would take place, consistent with representations made to PB by Respondent.[21] According to AM, PB said that the money to be invested would be transferred to Dean Witter, which would open an account for AM. PB also told AM that before the investment took place, AM would receive "bonded paper to cover my investment ... [which] would be reinsured by ... a bank or by insurance."[22] Although AM had not previously heard of Dean Witter, he was assured by his local banker that Dean Witter was a "big company, a reliable company."[23] On July 17, 1996, PB forwarded documents to AM that he had received from Respondent relating to AIGUT.[24]

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[19] RX 12.

[20] Hearing Tr., pp. 35-36.

[21] Hearing Tr., pp. 38-41.

[22] Hearing Tr., p. 39.

[23] Id.

[24] RX 13.

Based principally on documents and information provided to AM from PB, on July 18, 1996, AM sent an application to AIGUT to invest $1,000,000 in AIGUT. The application form used by AM to invest in AIGUT notes that the "capital payment and transfer of units will be made through Dean Witter, Oklahoma City, Oklahoma."[25] It further requested "that you [AIOC] apply for the opening of an account in my name and that you send me the original documents."[26]

F. Respondent's Opening of an Account for AM

After receiving AM's application to invest in AIGUT, Hoffman informed Respondent that PB and CM had an individual who wanted to invest in the security. Hoffman requested that Respondent open an account for AM so that the customer could send his funds to Dean Witter.[27] On July 18, 1996, Hoffman faxed an AIGUT "Confidential Subscriber Profile" of AM to Respondent to establish a Dean Witter account for AM.[28] On July 19, 1996, Respondent, acting on information that he received from Hoffman, completed a new account form for AM, designating himself as the account registered representative.[29]

Believing that AM did not speak English, Respondent contacted CM in order to obtain additional information to complete AM's new account application.[30] On July 22, 1996, after

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[25] RX 14, p. 1.

[26] Id.

[27] Hearing Tr., p. 297.

[28] RX 15.

[29] Stipulations, ¶ 4; CX 3.

[30] Hearing Tr., pp. 297-298.

the account was opened, AM authorized Dean Witter to send all mailings to AM c/o [PB] & Partner.[31] The letter did not authorize PB or CM to act on behalf of AM.

G. AM's Purchase of AIGUT

On July 23, 1996, Respondent received a fax transmission from CM that enclosed a draft letter for Respondent to send to AIGUT subscribers regarding the Financial Guaranty Bond.[32] The draft letter read as follows:

> This is to inform you that your application has been received and account number ..... has been opened for you at Dean Witter Reynolds. Upon receipt of the investment funds into the above referenced account we will advise AIOC, LLC who is providing in the Collateral Account, a Financial Guaranty Bond, reinsured by a European AAA reinsurance company equaling 110% of your investment amount. I will notify you upon the arrival of the required Financial Guaranty Bond from AIOC, LLC.
>
> Yours faithfully,
> Dean Witter Reynolds, Inc., Oklahoma

According to Respondent, CM told him that "Hoffman was making arrangements for a Financial Guarantee Bond."[33] Respondent said that he called Hoffman who "confirmed that he was in the process of making arrangements for the Financial Guarantee Bond."[34] That same day, July 23, 1996, Respondent sent a letter to AM, c/o [PB] & Partner, in which he copied the language of the draft letter from CM, filling in AM's name, mailing address and account

[31] Stipulations, ¶ 5; RX 16.

[32] RX 17. Respondent's exhibit contained handwritten edits on the typed text. There is no indication in the Hearing record as to who made these handwritten edits.

[33] Hearing Tr., pp. 298-299.

[34] Hearing Tr., p. 299.

number.[35] Respondent sent the letter on Dean Witter letterhead adding his name, signature and title of "Associate Vice President, Investments."[36]

Consistent with Respondent's letter of July 23, 1996, the next day, AM sent a letter to his bank authorizing the transfer of $500,000 to Dean Witter.[37] On August 8, 1996, $499,984 ($500,000 minus a transfer fee) was wired into AM's account at Dean Witter.[38] Respondent testified that the Financial Guarantee Bond for AM's investment was delivered to his office after he informed Hoffman that AM's funds had been received.[39]

The Financial Guarantee Bond was issued by Lifeguard Reinsurance, Ltd., on August 1, 1996.[40] The bond was signed by L.E. Hooten,[41] listed the "Limit of Liability Amount" as $1,100,000, and stated in part:

> Notice of Termination Upon termination, a written notice thereof shall be given to Dean Witter Reynolds, Inc., by the Investor no later than sixty (60) days before termination.... All policies, application, demands and requests provided for this Bond shall be in writing and addressed to:

[35] RX 18.

[36] Id.

[37] RX 19.

[38] Stipulations, ¶ 7.

[39] Hearing Tr., pp. 301-302.

[40] CX 10.

[41] Respondent stated that he now understands that the Financial Guarantee Bond was a worthless document, but did not have that understanding in August 1996. Hearing Tr., p. 350. In a letter dated December 6, 1999, to NASDR, an attorney from Morgan Stanley Dean Witter (the successor of Dean Witter), noted:

> [w]ith the assistance from outside counsel, the Firm investigated the legitimacy of the Lifeguard 'Guaranty Bond' and the alleged reinsurance by Zurich, [RE]. We have since concluded that both Lifeguard Reinsurance Ltd. ('Lifeguard'), and the 'Guaranty Bond' were a fraud.... Lifeguard appears not to be licensed in any state.... Its largest assets included stock in a closely held corporation and a non-existent university corporation, plus bonds issued by the 'Dominion of Melchizedek,' another nonexistent entity. Mr. L.E. Hooten, the signatory of the Guaranty Bond, died on or about October 9, 1996. CX 13, p. 1.

Dean Witter Reynolds, Inc.
Keith Waddell, Associate Vice President
6305 Waterford Blvd., Suite 240
Oklahoma City, OK 73118

> Jurisdiction of Law The construction, validity and performance of this Bond shall be governed by the laws of Oklahoma and any applicable laws of the United States of America.

Respondent testified that after receiving the bond, he took the document to the firm's operations manager, and was told that the instrument could not be booked into the account since it was not a negotiable instrument. After telling CM and Hoffman that the bond "was not a registered security that we could book into a Dean Witter account," he was instructed by them to "put it in a file and hold it for them," which he did.[42]

Respondent further testified that when he first saw the bond, he was surprised to see that it referenced him and Dean Witter.[43] Though surprised, he said that the references did not concern him,[44] and he did not make any effort to have his name removed from the document.[45] Respondent failed to discuss the document's reference of the firm with Dean Witter's management, or to seek permission to reference the firm in the document.[46] According to Respondent, it just did not occur to him to inform Dean Witter that its name was referenced on the bond's Notice of Termination.[47] Nor did Respondent get the firm's permission to receive

[42] Hearing Tr., p. 306.

[43] Hearing Tr., p. 415.

[44] Id.

[45] Hearing Tr., pp. 369-370.

[46] Hearing Tr., pp. 362-363, 403, 417.

[47] Hearing Tr., p. 417.

notices of termination as called for in the bond, or to hold the bond at Dean Witter in AM's file.[48]

When Respondent received the bond, he also did not attempt to verify the *bona fides* of its issuer, Lifeguard Reinsurance Ltd., since, as he stated, "nobody had requested that I check it out and, ... all I was told [was] that there was going to be a bond come in and it came in. That's all I was asked to do is to notify the people involved when the bond arrived at Dean Witter."[49] Respondent further stated that, to determine if the bond was reinsured by a "European AAA Reinsurance Company," as mentioned in his July 23, 1996 letter to AM, he contacted Hoffman who "told me they were getting reinsurance from Zurich RE. I confirmed that with [CM]."[50] Respondent admitted that he was never informed that CM actually received the insurance papers from Zurich RE and never actually saw the documents himself.[51]

In a letter dated August 12, 1996, Respondent informed AM:[52]

> This is to notify you that the required Financial Guaranty bond, maturity July 29, 1997, equaling 110% of your investment of $500,000 U.S. dollars has been reinsured by Zurich RE and has been pledged to your benefit.
>
> Please give us your approval to transfer $499,984.00 U.S. dollars ($500,000.00 less wire transfer fee of $16.00) to the investment account of American Investment Opportunity Co. LLC account number 325-057487-028.

[48] Hearing Tr., p. 363.

[49] Hearing Tr., p. 302.

[50] Hearing Tr., p. 302.

[51] Hearing Tr., p. 352. In Morgan Stanley Dean Witter's letter to the NASDR dated December 6, 1999, the firm noted that "[w]hile Zurich, [RE] is a viable entity, we have no documentation of, and have been unable to verify, any actual reinsurance of the Guaranty Bond by Zurich, [RE]. It is the Firm's understanding that Mr. Waddell's letter referring to Zurich, RE was based solely on the representations of others." CX 13, p. 2.

[52] Stipulations, ¶ 8; CX 4; RX 23.

The letter appeared on Dean Witter letterhead and was signed by Respondent as "Associate Vice President, Investments."[53] Respondent failed to notify AM of his inability to deposit the Financial Guarantee Bond into a collateral account at Dean Witter, as represented in the July 23 letter, or the instructions from Hoffman and CM to place it in a file. He also failed to inform AM that the bond he received listed the limit of liability amount as $1,100,000, despite the fact that AM was investing only $500,000.

Based on the representations made by Respondent in his August 12, 1996 letter, on August 13, 1996, AM faxed Respondent a letter in which he referenced Respondent's earlier letter and gave him approval to transfer $499,984.00 to the investment account of AIOC.[54] Thereafter, on August 14, 1996, Respondent caused $499,984.00 to be transferred from AM's Dean Witter account to the Dean Witter account of AIOC.[55]

H. AM's Attempt to Terminate His Investment in AIGUT

On January 31, 1997, PB sent AM a letter informing him that a newly created Financial Guarantee Bond for $550,000 had been deposited for his benefit with Dean Witter.[56] A separate letter from PB that same day notified AM that his investment had produced a bonus dividend of 6 percent, equaling $30,000. In a letter dated February 14, 1997, Respondent

[53] CX 4; RX 23.

[54] Stipulations ¶ 11; CX 5; RX 24.

[55] Stipulations ¶ 12; Hearing Tr., p. 309.

[56] RX 26.

confirmed to AM that he had received the $30,000 bonus dividend.[57] In early May 1997, AM received an additional $20,000 as a bonus dividend for his investment.[58]

In a letter dated May 26, 1997, in accordance with the Notice of Termination provision in the Financial Guarantee Bond, AM instructed Respondent to terminate his investment in AIGUT and to "cash the Financial Guaranty Bond."[59] After receiving those instructions, Respondent called CM and Hoffman. Hoffman told Respondent that "he [Hoffman] would be the one to actually handle the bond since he purchased the bond in the first place."[60] CM agreed with Hoffman, and so when Hoffman asked Respondent to send the bond to him, Respondent obliged.[61] Respondent admits that, despite the fact that the bond was to insure the payment to AM, he never sought or obtained permission from AM to send the bond to Hoffman.[62] Respondent also never sought instructions from Dean Witter prior to sending the bond to Hoffman.[63]

Respondent took no further steps to attempt to return AM's funds.[64] In February 1998, AM commenced an action in the Superior Court of California for the County of Los Angeles against Morgan Stanley Dean Witter arising out of the actions involving his investment

[57] RX 28.

[58] RX 34; Hearing Tr. p. 50.

[59] RX 35.

[60] Hearing Tr., p. 314.

[61] Hearing Tr., pp. 314-315.

[62] Hearing Tr., pp. 365-366.

[63] Hearing Tr., p. 166.

[64] Hearing Tr., pp. 417-418.

in AIGUT at Dean Witter.[65] Morgan Stanley Dean Witter settled that suit with AM in April 1999 with the payment of $350,000 to AM.[66]

I. Dean Witter's Review of Respondent's Activities

Respondent testified that while he conducted this business involving AIGUT, all of his correspondence was handled in accordance with Dean Witter procedures, in that all outgoing correspondence was approved and all incoming correspondence was reviewed by a manager.[67] Respondent emphasized this point to attempt to establish that Dean Witter was aware of and approved of his actions. The Dean Witter branch manager, William Lacy, acknowledged his responsibility for reviewing correspondence but claimed that he did not recall seeing or approving certain critical pieces of correspondence involving AIGUT.[68] Specifically, Lacy did not recall approving Respondent's July 23 or August 12, 1996 letters to AM.[69]

The Hearing Panel found it unnecessary to determine whether Dean Witter's management reviewed all of Respondent's correspondence relating to AIGUT for purposes of deciding liability in this case. The Hearing Panel found, as Lacy testified, that administration of collateral accounts was not one of Respondent's responsibilities at the firm, and that an "AIOC Unit Trust" was not an authorized product for Dean Witter representatives.[70] Lacy stated that it was not among Respondent Waddell's duties in 1996 to notify customers of pledges of bonds

[65] RX 78, p. 1.

[66] RX 78, p. 2.

[67] Hearing Tr., p. 288.

[68] Hearing Tr., pp. 154-165.

[69] Hearing Tr., pp. 158-160.

[70] Hearing Tr., p. 156.

for their benefit,[71] or to receive notices under such financial guaranty bonds.[72] According to Lacy, the firm never gave Respondent permission to be listed on the bond to receive a notice of termination.[73] Nor did Respondent have permission to send a bond for the benefit of a customer to a third party.[74] Finally, Lacy testified that the Dean Witter office did not hold securities for customers.[75]

III. LEGAL DISCUSSION

A. Untrue Statements of Material Fact (NASD Conduct Rules 2110 and 2120, Section 10(b) of the Exchange Act, and SEC Rule 10b-5 thereunder)

The Complaint alleged that by making untrue statements of material fact Respondent Waddell violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120. Section 10(b) of the Exchange Act makes it "unlawful for any person ... to use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."[76] Rule 10(b)-5(b) makes it unlawful to "make any untrue statement of a material

[71] Hearing Tr., p. 160

[72] Hearing Tr., pp. 165-166.

[73] Hearing Tr., p. 166.

[74] Id.

[75] Hearing Tr., pp. 166-167.

[76] 15 U.S.C. § 78j(b).

fact or to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading...."[77]

To prove a violation of Rule 10b-5(b), it must be shown that a respondent either intentionally or recklessly[78] made untrue statements in communications with a customer, that the untrue information contained in the statements was material, and made in connection with the purchase or sale of securities.[79] A fact is considered material if there is a substantial likelihood that the information "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[80]

The NASD has previously held that NASD Conduct Rules 2110, 2120 and SEC Rule 10b-5 are each "designed to ensure that sales representatives fulfill their obligation to their customers to be accurate when making statements about securities." DBCC No. 9 v. Euripides, Complaint No. C9B950014, 1997 NASD Discip. LEXIS 45 (NBCC July 28, 1997), at * 16-17. "A salesperson has a duty to make an adequate independent investigation in order to ensure that his representations to customers have a reasonable basis." In re Frank W. Leonesio, 48 S.E.C. 544, 548 (1986).

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[77] The Hearing Panel found as a preliminary matter, and Respondent did not contest, that AM's investment in AIGUT constituted a security as defined under Section 3(a)(10) of the Exchange Act.

[78] Recklessness has been defined as "not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Hollinger v. Titan Capital Corp., 914 F. 2d 1564, 1569 (9th Cir. 1990).

[79] For Section 10(b) of the Exchange Act and Rule 10b-5, the transactions must also involve interstate commerce or the mails, or a national securities exchange. Respondent used the telephone and mails to send letters to AM and others in connection with this transaction. See SEC v. Hasho, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992).

[80] Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976)).

In reviewing the evidence , the Hearing Panel found that Respondent made materially untrue representations to AM regarding the Financial Guarantee Bond including:

- that it was reinsured by a European AAA reinsurance company;
- that it had been reinsured by Zurich RE and pledged to AM's benefit; and
- that it would be held in a collateral account at Dean Witter.

The Hearing Panel also found Respondent's representations regarding Dean Witter's involvement in the transaction to constitute materially untrue information.

In Respondent's July 23, 1996 letter to AM, Respondent represented that "AIOC, LLC ... is providing in the Collateral Account, a Financial Guaranty Bond, reinsured by a European AAA reinsurance company equaling 110% of your investment amount."[81] With these representations regarding the nature of the investment and the risk involved, the Hearing Panel found that Respondent's responsibilities went well beyond merely facilitating a transaction. By this letter, Respondent became obligated to make a reasonable effort to verify that a collateral account was established and that there was, in fact, a Financial Guarantee Bond reinsured by a European AAA reinsurance company, as specified in the letter. The Hearing Panel found that Respondent was reckless in not taking reasonable steps to verify any of the information prior to making those representations to the customer.

Respondent's representations in his July 23 letter to AM, combined with his August 12, 1996 letter in which he said "that the required Financial Guaranty bond, ... *has been reinsured by Zurich RE and has been pledged to your benefit*" (emphasis added) would clearly lead a reasonable investor to believe that the Financial Guarantee Bond was in a "collateral account"

[81] CX 3.

maintained at Dean Witter.[82] However, Respondent knew that the Financial Guarantee Bond was being held in a file, not in a Collateral Account at Dean Witter, and had no reasonable basis for stating that the bond had been reinsured by Zurich RE since he had never seen any documentation from Zurich RE.

Respondent claimed that he relied on Hoffman to verify that the bond had been reinsured by Zurich RE. However, that reliance was not reasonable, given the significant conflicts of interest that existed. Hoffman represented the party that was going to receive the funds from AM. He had a motive for misrepresenting the nature of the insurance product. As noted in Hanly, *supra*, "a salesman may not rely blindly upon the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigations."

The Hearing Panel finds that due to the fact that Hoffman was his best customer, representing approximately 58 percent of his total commissions, Respondent was blinded by his desire to please Hoffman, at the cost of failing to meet his obligations to AM. Given that the investment in AIGUT was from a small issuer of recent origin, Respondent clearly was obligated to investigate beyond merely relying on Hoffman. Thus, the Hearing Panel finds that Respondent was reckless in his failure to attempt to independently verify the facts critical to AM's investment.

The Hearing Panel also found that Respondent fostered the false impression that Dean Witter authorized and supported Respondent's actions and was involved in the transaction. This misinformation was communicated through Respondent's use of Dean Witter's letterhead

[82] CX 4.

and of his own title at Dean Witter in correspondence with AM. Respondent also knowingly allowed Dean Witter's name to be used on other critical documents, including the Financial Guarantee Bond. The Hearing Panel therefore found that references to Dean Witter constituted material information under Rule 10b-5 and NASD Rule 2120.

Consequently, the Hearing Panel found that Respondent Waddell violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120 as alleged in the first cause of the Complaint.

B. Unauthorized Transfer of Customer Assets (NASD Conduct Rule 2110)

NASD Conduct Rule 2110 requires that a member "in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." The ethical standards imposed on members in Rule 2110 apply equally to persons associated with members.[83] Respondent admits that he transferred the Financial Guarantee Bond to Allan Hoffman without first getting explicit permission from customer AM, the beneficiary of the bond.

Enforcement acknowledged, and the Hearing Panel likewise found, that Respondent transferred the bond to Hoffman in an attempt to assist the customer. Respondent's actions, however, were contrary to AM's directions, which were to cash the bond on his behalf by dealing directly with the insurance company. Instead of following the directions of his customer, Respondent again acceded to the directions of Hoffman, who had a conflicting interest in AM's investment. Had Respondent reasonably determined that he needed to provide the bond to Hoffman in order to cash it on the customer's behalf, he should have advised AM and gotten his consent.

[83] NASD Rule 0115.

The Hearing Panel therefore found that Respondent's acts in contravention of customer AM's instructions and without the customer's prior consent constituted a violation of Rule 2110 as alleged in the second cause of the Complaint.

C. Private Securities Transactions (NASD Conduct Rules 2110 and 3040)

NASD Rule 3040 prohibits an associated person from participating in a private securities transaction unless the person has complied with the requirements of the Rule. Rule 3040(e) defines a private securities transaction as "any securities transaction outside the regular course or scope of an associated person's employment with a member...." Rule 3040(b) requires that "[p]rior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction...."

The Rule is designed to protect member firms from "exposure to loss and litigation, and investors from the hazards of unmonitored sales." In re William Louis Morgan, Exchange Act Release No. 32744, 54 S.E.C. Docket 1611, 1993 SEC LEXIS 2027, at *8 (Aug. 12, 1993). When an associated person fails to comply with Rule 3040 investors are "deprived of the brokerage firm's oversight and supervision, a protection they have a right to expect." Morgan, 1993 SEC LEXIS 2027, at *20-21. A violation of NASD Conduct Rule 3040 is also a violation of NASD Conduct Rule 2110.

Respondent admits that he never provided Dean Witter with written notice as specifically set forth in Rule 3040, but contends that he met his obligation since his manager reviewed and approved correspondence that contained information required in a notice under

Rule 3040. Even if all of the required information were contained in a compilation of the incoming and outgoing correspondence, it is clear that a firm's review of correspondence is not an adequate substitute for the notice requirement under Rule 3040. The Rule requires notification *in advance* of the activities that sets forth the parameters of the representative's involvement. Clearly by the time a supervisor pieces together information gleaned through a review of correspondence received over a period of time, the registered individual may already have undertaken the outside securities activity in violation of the Rule.

Under the Rule, the details and parameters of the registered person's outside activities, including his compensation, if any, are set forth in a single document, and presented to management for review. The firm can then make an affirmative determination whether to approve the activities and can establish any necessary procedures to properly supervise the representative. The determination would then be documented in the firm's books and records.

By reason of the foregoing, the Hearing Panel found that Respondent violated NASD Conduct Rules 2110 and 3040 by engaging in a private securities transaction, as alleged in the third cause of the Complaint.

IV. SANCTIONS

A. Untrue Statements of Material Fact (NASD Conduct Rules 2110 and 2120, Section 10(b) of the Exchange Act, and SEC Rule 10b-5 thereunder)

For making material misrepresentations where the acts were determined to be intentional or reckless, the NASD Sanction Guidelines ("Guidelines") recommend that the individual be fined in the range of $10,000 to $100,000 and suspended in all capacities for ten

business days to two years. In egregious cases, adjudicators may consider barring the individual.[84]

For this violation, Enforcement requested that Respondent be barred and ordered to pay restitution of $99,984, plus interest.[85] In its recommendation, Enforcement argued that Respondent's actions constituted an egregious violation, due to the extent of loss to the firm and customer, and the extent of the misrepresentations. Enforcement noted that Respondent sent correspondence without checking the representations in those letters and took no steps to help AM collect his money.[86]

In arguing that a bar be imposed, Enforcement urged the Hearing Panel to compare the facts in the instant case to those in In re Coastline Financial, Inc., et al, Exchange Act Rel. No. 41989 (October 7, 1999). In Coastline, the SEC sustained an NASD decision which barred the firm's president and sole owner, expelled the firm from NASD membership and ordered a joint and several fine of $50,000. In that case, the individual respondent made material misstatements and omitted material facts in connection with the offer and sale of 63 promissory notes to 48 investors. The promissory notes were issued by a corporation that was wholly owned by the registered individual who was making the recommendations to customers.

The misconduct in the instant case, however, is not as severe as the misconduct in Coastline. Respondent Waddell did not make the number of misrepresentations that were made in Coastline. Nor did he have as direct a financial incentive for the misrepresentations. While the Hearing Panel found that the misconduct engaged in by Respondent was somewhat

[84] NASD Sanction Guidelines, p. 96 (2001 ed.).

[85] Hearing Tr., p. 500. Enforcement did not seek a fine, citing Notice to Members 99-86, which amended the Guidelines by eliminating fines in some cases when an individual is barred.

[86] Hearing Tr., p. 500.

egregious and resulted in severe consequences for AM, the Hearing Panel did not find that a bar was warranted in this case.

Respondent argued that this was not an egregious case and that a bar was not warranted.[87] According to Respondent, this matter should be viewed as simply "as an accommodation to a customer ...."[88] In reviewing the principal considerations under the Guidelines, Respondent noted that there was no prior or similar conduct and that it involved only one transaction and customer.[89] Finally, he noted that he had no beneficial interest in the underlying product and received no direct compensation for the transaction.[90]

In considering the Guidelines' principal considerations, in addition to those discussed above, the Hearing Panel found that Respondent did not accept responsibility for or acknowledge his misconduct. His actions resulted in a direct and significant injury to a customer for which Respondent never attempted to make restitution. Also, Respondent acted recklessly as he was blinded by the desire to satisfy one customer at the cost of another.

Based on the foregoing under the first cause of the Complaint, the Hearing Panel orders that Respondent be suspended in all capacities for two years. After the two year period, if Respondent attempts to become associated with a member firm, he will thereafter be required to be with a member firm that will agree to provide special supervision of his activities.[91]

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[87] Hearing Tr., pp. 515, 524.

[88] Hearing Tr., p. 518.

[89] NASD Sanction Guidelines, pp. 9-10 (2001 ed.); Hearing Tr., p. 515.

[90] Hearing Tr., p. 518.

[91] The special supervision shall include, at a minimum: (1) a monthly review of all account statements for Respondent's customers by the member firm's Compliance Department; and (2) designation of a General Securities Principal to monitor any outside business activities engaged in by Respondent while he is associated with the firm. After Respondent has been registered with a member firm and subject to such

Respondent is also ordered to pay customer AM $100,000, plus interest, in restitution.[92] Finally, Respondent is fined $10,000 for making material untrue statements as alleged in the first cause of the Complaint.

B. Unauthorized Transfer of Customer Assets (NASD Conduct Rule 2110)

The Guidelines do not include recommended sanctions for this specific violation. According to the Guidelines, when "violations are not addressed specifically, Adjudicators are encouraged to look to the guidelines for analogous violations."[93] In this case, the most analogous Guidelines are for unauthorized transactions. A principal consideration for setting sanctions under those Guidelines is whether a respondent misunderstood his or her authority or the terms of the customer's orders.[94] The Guidelines recommend a fine of $5,000 to $75,000 plus the amount of a respondent's financial benefit.[95] In cases involving customer losses, the Guidelines also suggest suspending an individual in any or all capacities for 10 to 30 business days.[96]

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special supervision for a period of two years, he may thereafter apply to the Director of the NASDR District in which his employing firm is located, to have the special supervision requirement lifted. (*See* DBCC No. 7 v. Velasco, Complaint No. C07950057, 1996 NASD Discip. LEXIS 50 (NBCC October 14, 1996) where a respondent's special supervision was subject to review by an NASDR District office.)

[92] The amount of restitution was determined by subtracting the $350,000 customer AM obtained in the settlement, and $50,000 that AM received in "dividends" during the time he owned the securities, from his original investment of $500,000. The interest is calculated pursuant to 26 U.S.C. § 6621(a)(2), i.e., the interest rate used by the Internal Revenue Service to determine interest due on the underpaid taxes. The Internal Revenue Service rate, which is adjusted each quarter, reflects market conditions, and thus approximates the time value of money for each quarter in which the customer lost the use of his funds. The interest will accrue from June 1, 1997, the first full month after the customer requested that his investment be terminated.

[93] NASD Sanction Guidelines, p. 2 (2001 ed.).

[94] NASD Sanction Guidelines, p. 102 (2001 ed.).

[95] Id.

[96] Id.

Enforcement acknowledged in its recommendation that Respondent's sending of the bond to Hoffman "was done to benefit the customer....[H]e didn't send out this bond in order to try to make a commission or to get over on the customer that way ...."[97] For this violation, Enforcement requested that Respondent be suspended for six months and fined $10,000.[98]

The Hearing Panel found that Respondent's actions, while not intended to harm the customer, were nonetheless contrary to the customer's instructions. Respondent is therefore fined $5,000 under the second cause of the Complaint. Since Respondent's transfer of the Financial Guarantee Bond did not directly lead to the customer losses, the Hearing Panel found that no suspension is warranted under this cause.

C. Private Securities Transactions (NASD Conduct Rules 2110 and 3040)

The Guidelines for private securities transactions recommend that an associated person be fined in a range of $5,000 to $50,000, plus the amount of the respondent's financial benefit.[99] The Guidelines also recommend suspending an individual in any or all capacities for ten business days to one year. In egregious cases, the Guidelines recommend that the Adjudicator consider a suspension of up to two years or a bar.[100]

The principal considerations in establishing the sanctions are: (1) whether respondent had a proprietary or beneficial interest in, or otherwise affiliated with the selling enterprise; (2) whether respondent attempted to create the impression that the employer sanctioned the activity, for example, by using the firm's facilities, name and goodwill; (3) whether the selling

[97] Hearing Tr., p. 503.

[98] Hearing Tr., p. 504.

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

[100] Id.

away involved customers of the firm; (4) whether the individual provided the firm with verbal notice of all relevant facts, and if so, the firm's response, if any; and (5) whether respondent sold the product after some prohibition on its sale was imposed by the firm.[101]

Enforcement argued that Respondent used the firm's name and premises to create the impression that Dean Witter was involved in the transaction.[102] Enforcement noted that Rule 3040 protects not only investors, but member firms, who end up paying for activities of its registered representatives, as was done in this case. Enforcement considered this violation to be egregious and, based on its analysis, recommended that Respondent be barred for engaging in the private securities transaction.[103]

Based on a review of its findings, and the principal considerations, the Hearing Panel found that Respondent's actions were egregious, but did not warrant a bar. The Hearing Panel found as mitigating factors that Respondent did not have a beneficial interest in the selling enterprise or issuer. The Hearing Panel found that Respondent's use of the firm name, premises and letterhead were aggravating factors in considering the appropriate sanctions. The Hearing Panel also considered that AM was a customer of the firm, albeit a new customer, to be an aggravating factor.

Therefore, for the third cause of the Complaint, the Hearing Panel orders that Respondent be suspended in all capacities for two years. This period of suspension shall run concurrently with the period of suspension ordered for violations under the first cause of the

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[101] Id.

[102] Hearing Tr., pp. 501-502.

[103] Hearing Tr., p. 503.

Complaint. As also required under the first cause, after the two year period, if Respondent attempts to become associated with a member firm, he will thereafter be required to be with a member firm that will agree to provide special supervision of his activities.[104] Respondent is also fined $25,000 under this cause of the Complaint.[105]

V. CONCLUSION

The Hearing Panel found that Respondent Waddell violated (1) NASD Conduct Rules 2110 and 2120, Section 10(b) of the Exchange Act, and SEC Rule 10b-5 thereunder, by making untrue statements of material fact in connection with a securities transaction; (2) NASD Conduct Rule 2110 for the unauthorized transfer of customer assets; and (3) NASD Conduct Rules 2110 and 3040 for engaging in a private securities transaction as alleged in the Complaint. The Hearing Panel suspended Respondent from associating with any NASD member firm in any capacity for a period of two years under the first and third causes of the Complaint and ordered that he thereafter be subject to special supervision with any member firm with which he becomes associated.[106] The Hearing Panel also ordered that Respondent pay restitution of $100,000, plus interest, to customer AM. Finally, the Hearing Panel also fined Respondent an aggregate of $40,000[107] and assessed costs against the Respondent in the amount of $2,455

[104] See footnote 91, *supra*, for a description of the special supervision requirements.

[105] In assessing the fines in this case, the Hearing Panel considered arguments and documentation presented regarding Respondent's ability to pay, and determined that Respondent has the means to pay the fine. Respondent may pay the fine on the installment basis established by the NASD.

[106] See footnote 91, *supra*, for a description of the special supervision requirements.

[107] Respondent was fined $10,000 for making untrue statements of material fact, $5,000 for the unauthorized transfer of customer assets, and $25,000 for engaging in private securities transactions.

consisting of a $750.00 administrative fee and $1,705 for the cost of the Hearing transcript.[108] These sanctions shall become effective on a date set by the Association, but not earlier than 30 days after this decision becomes the final disciplinary action of the Association, except that if this decision becomes the final disciplinary action of the Association, the suspension shall become effective with the opening of business on July 2, 2001, and end at the close of business on July 1, 2003.

Hearing Panel

by: _____
Gary A. Carleton
Hearing Officer

Copies to:

Via Overnight Courier and First Class Mail
Charles K. Waddell
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Via First Class Mail and Electronic Transmission
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[108] 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.