NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

DONNER CORPORATION INTERNATIONAL
(N.K.A. NATIONAL CAPITAL SECURITIES, INC.)
(CRD #37702)
6801 Broadway Extension, Suite 203
Oklahoma City, OK 73116,

JEFFREY L. BACLET
(CRD #2022409)
2613 W. Curie #B
Santa Ana, CA 92704,

VINCENT M. UBERTI
(CRD #2618595)
2405 W. Adams Street
Santa Ana, CA 92704-5535,

and

PAUL A. RUNYON
(CRD #3159920)
24841 Woodside Lane
Lake Forest, CA 92630,

Respondents.

Disciplinary Proceeding
No. CAF020048

HEARING PANEL DECISION

Hearing Officer – SW

June 7, 2004

The Hearing Panel expels Respondent Donner Corporation International (N.K.A. National Capital Securities, Inc.) and bars Respondent Jeffrey L. Baclet in all capacities for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2210, and 2110, by recklessly issuing misleading research reports as alleged in counts one through five of the Complaint. In

light of the expulsion and the bar, the Hearing Panel did not impose any additional sanctions on Respondents Donner and Baclet for violating the supervision requirements set forth in NASD Conduct Rules 3010 and 2110, as alleged in counts six and seven of the Complaint.

The Hearing Panel suspends Respondent Vincent M. Uberti for two years in all capacities and fines him $20,000 for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2210, and 2110, by recklessly participating in the issuance of misleading research reports as alleged in counts one through five of the Complaint.

The Hearing Panel suspends Respondents Uberti and Paul A. Runyon each for six months in all capacities, fines them each $20,000, and directs each to requalify as a general securities principal and general securities representative for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2210, and 2110, by issuing two misleading research reports as alleged in counts eight through eleven of the Complaint.

Appearances

Gary A. Carleton, Esq., Counsel, and Edward G. Rosenblatt, Esq., Assistant Director, Washington, DC, for the Department of Enforcement.

Dr. Vance Coan, secretary for Donner Corporation International (N.K.A. National Capital Securities, Inc.) as representative of Donner.

Jeffrey L. Baclet, pro se.

Vincent M. Uberti, pro se.

Paul A. Runyon, pro se.

DECISION

I. Introduction

On October 15, 2002, the NASD Department of Enforcement ("Enforcement") filed its original Complaint in this matter, and on October 21, 2002, Enforcement filed an eleven-count Amended

Complaint ("Complaint") against four respondents. Counts one through seven of the Complaint address the research reports issued by Respondent Donner Corporation International[1] ("Donner" or the "Firm"). Counts eight through eleven of the Complaint address two research reports issued under the name Lincoln Equity Research, LLC ("Lincoln") by Respondents Vincent M. Uberti ("Uberti") and Paul A. Runyon ("Runyon"), while they were registered with Lloyd, Scott & Valenti, Ltd. ("Lloyd").

A. Counts One though Seven of the Complaint: Donner Research Reports

The first three counts of the Complaint charge that Donner, through Respondent Jeffrey L. Baclet ("Baclet"), the Firm's president and sole proprietor, and Uberti, a vice president of marketing,[2] issued 25 research reports that:[3] (1) failed to disclose material information, in violation of NASD Conduct Rules 2210(d)(1)(A) and 2110; (2) contained exaggerated, misleading, and false statements, in violation of NASD Conduct Rules 2210(d)(1)(B) and 2110; and (3) were fraudulent due to the omissions and the exaggerated, misleading, and false statements, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110.

Count four of the Complaint alleges that in research reports for 51 companies,[4] Donner, Baclet, and Uberti concealed compensation arrangements with the subject companies, in violation of NASD Conduct Rule 2110.

[1] Now known as "National Capital Securities, Inc."

[2] Uberti testified that he was not a corporate officer of Donner and that the vice president title was a courtesy title that did not include any management or supervisory responsibilities. (Tr. II 560-561).

[3] Uberti is charged with violations for only 22 of the 25 research reports.

[4] Uberti is charged with violations for the research reports for only 44 of the 51 companies.

Count five of the Complaint alleges that Donner, Baclet, and Uberti violated NASD Conduct Rule 2110 by their: (i) failure to disclose material information in the 25 research reports as alleged in count one of the Complaint; (ii) inclusion of exaggerated, misleading, and false statements in the 25 research reports as alleged in count two of the Complaint; and (iii) failure to disclose Donner's compensation arrangements with the 51 subject companies in the research reports as alleged in count three of the Complaint.

Count six of the Complaint alleges that Donner and Baclet failed to have Donner's research reports signed by a principal, in violation of NASD Conduct Rules 2210(b)(1) and 2110.

Count seven of the Complaint alleges that Donner and Baclet failed to establish and maintain written supervisory procedures pertaining to the preparation and dissemination of the Firm's research reports, in violation of NASD Conduct Rules 3010 and 2110.

B. Counts Eight through Eleven of the Complaint: Lincoln Research Reports

Counts eight through ten of the Complaint charge that, while registered with NASD member Lloyd, Uberti and Runyon, through Lincoln, a non-NASD member firm that they had formed, issued two research reports that: (1) failed to disclose material information, in violation of NASD Conduct Rules 2210(d)(1)(A) and 2110; (2) contained exaggerated, misleading, and false statements, in violation of NASD Conduct Rules 2210(d)(1)(B) and 2110; and (3) were fraudulent due to the omissions and misstatements, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 promulgated thereunder, and NASD Conduct Rule 2120.

Count eleven of the Complaint alleges that Uberti and Runyon violated NASD Conduct Rule 2110 by their: (i) failure to disclose material information in the two research reports as alleged in count

eight of the Complaint; and (ii) inclusion of exaggerated, misleading, and false statements in the two research reports as alleged in count nine of the Complaint.

C. Respondents Denied Liability and Hearing Held to Consider the Allegations

Each Respondent filed an answer to the Complaint, denied the charges, and requested a hearing. The Hearing Panel, composed of an NASD Hearing Officer, a former member of the District 3 Committee, and a former member of the District 8 Committee, held a two-phased hearing on this matter.[5] Phase I of the hearing consisted of testimony pertaining to counts eight through eleven of the Complaint that contained allegations against Uberti and Runyon.[6] Phase II of the hearing dealt with counts one through seven of the Complaint that contained allegations against Donner, Baclet, and Uberti.[7]

II. Findings of Fact and Conclusions of Law

A. The Respondents

1. Donner Corporation International

Donner first became a registered broker-dealer and member of NASD in October 1996. (Tr. II 784). The Firm was registered at all times relevant to this proceeding. NASD cancelled the Firm's membership on November 18, 2002. (CX-NC-4, at 2). During the relevant period, Baclet was the Firm's president and sole proprietor. (Tr. II 899).

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[5] References to the testimony set forth in the transcripts of the Hearing are designated as "Tr. __" for the first phase of the Hearing and "Tr. II __" for the second phase of the Hearing, with the appropriate page number. References to the exhibits submitted by Enforcement for both phases of the Hearing are designated as "CX-."

[6] References to the exhibits submitted by Enforcement that pertain *only* to counts eight through eleven of the Complaint are designated as "CX-LE-__", and references to the exhibits submitted by Uberti and Runyon that pertain only to counts eight through eleven of the Complaint are designated at "RX-LE-__."

[7] References to the exhibits submitted by Enforcement that pertain *only* to counts one through seven of the Complaint are designated as "CX-NC-__", and references to the exhibits submitted by Donner, Baclet, or Uberti that pertain only to counts one through seven of the Complaint are designated at "RX-NC-__."

2. Jeffrey L. Baclet

At all times relevant to this proceeding, Baclet was registered with NASD through Donner as a general securities principal and general securities representative. (CX-NC-7, at 6). Baclet also was the Firm's financial and operations principal and options principal. (*Id*.). Baclet initially became registered as a general securities representative in February 1990. (CX-NC-7, at 12). In July 1995, Baclet became registered as a general securities principal. (CX-NC-7, at 7). In October 1996, Baclet registered as a general securities principal and general securities representative with NASD through Donner.[8] (CX-NC-7, at 6). On October 22, 2002, Baclet's registrations with Donner were terminated. (*Id*.).

3. Vincent M. Uberti

Uberti first became a registered general securities representative in November 1995. CX-3, at 6). He was registered as a general securities representative through Donner on April 30, 1998, and as a general securities principal on July 17, 2001. (CX-3, at 5). Although Donner did not submit a Form U-5 terminating Uberti's registrations as a general securities representative and a general securities principal until May 8, 2002, Uberti terminated his association with Donner in July 2001 and began his own research firm. (CX-3, at 5; Tr. II 832).

From July 18, 2001 until November 8, 2001, Uberti was also registered as a general securities representative and a general securities principal at Lloyd, another NASD member firm. (CX-3, at 4).

4. Paul A. Runyon

[8] In 1997, Baclet became registered as an options principal and financial operations principal with Donner. (CX-NC-7, at 6).

Runyon first became registered as a general securities representative in January 1999. (CX-4, at 5). He was registered as general securities representative through Donner from April 10, 2000 until July 11, 2000,[9] when his registration was terminated. However, Runyon continued

[9] Runyon was employed at Donner from April 2000 until July 2001, when he left with Uberti. (CX-4, at 5; Tr. 459).

to be employed by Donner until July 2001. Runyon also was a registered general securities representative and a general securities principal through Lloyd from July 20, 2001 until November 8, 2001. (CX-4, at 4).

B. Jurisdiction

When Enforcement filed its original Complaint in this matter on October 15, 2002, Donner and Baclet were registered with NASD. Accordingly, NASD has jurisdiction over Donner and Baclet.

NASD also has jurisdiction over Uberti and Runyon pursuant to Article V, Section 4 of the NASD's By-Laws, which grants NASD jurisdiction over respondents for two years following the termination of their registrations with a member firm for conduct that commenced while the respondent was registered, if the Complaint is filed within two years after the respondent's registration terminated.

C. The Donner Research Reports

From approximately March 1999 through May 2002, Donner regularly issued research reports on various companies. The Firm routinely identified companies with little or no trading volume, priced at less than $5 per share, and through cold calls offered to prepare research reports on those companies. (Tr. II 60). Donner's research reports generally increased the visibility of a subject company and the value of that company's underlying stock. (Tr. II 68).

Baclet testified that the Firm would not agree to prepare a research report if the company did not have what he deemed a "viable product," was immoral, was "anti-family," or was harmful to the community. (Tr. II 865). Baclet testified that he would not authorize Donner to prepare a research report if the report could not be positive. (Tr. II 882).

1. Counts One and Two: 25 Donner Research Reports Violated the Sales Literature Disclosure Requirements of NASD Conduct Rule 2210

a. The 25 Donner Research Reports were Misleading

Count one of the Complaint alleges that Donner, Baclet, and Uberti violated the sales literature disclosure requirements of Conduct Rules 2210(d)(1)(A) and 2110 by issuing research reports that failed to disclose material information about the subject company. Count two of the Complaint alleges that Donner, Baclet, and Uberti violated the sales literature disclosure requirements of Conduct Rules 2210(d)(1)(B) and 2110 by issuing research reports that contained misleading, exaggerated, and false statements.

Conduct Rule 2210 governs the dissemination of written or electronic communications with the public. The Rule prohibits members and associated persons from making exaggerated, unwarranted or misleading statements or claims in their public communications. All public communications must be based upon the principles of fair dealing and good faith, provide a sound basis for evaluating the facts discussed, and not omit material facts or qualifications that would cause the communication to be misleading in light of its context.[10]

[10] Sub-part (A) of Conduct Rule 2210(d)(1) required "[a]ll member communications with the public [to] be based on principles of fair dealing and good faith and [to] provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered." It further provided that "[n]o material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communication to be misleading." (*See NASD Notice to Members 98-83*.)

Sub-part (B) of Rule 2210(d)(1) prohibited members from using "exaggerated, unwarranted or misleading statements or claims" in all "public communications," and it also forbade members to "directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading." (*Id.)*

Overall, these standards require a full and fair description of any securities product or service, including material information such as risks or costs of the particular product or service. The content must be accurate and must provide sufficient information to evaluate the facts with

respect to the securities products or services discussed.

The test of materiality is whether a reasonable investor would consider the information significant. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). An omitted or misstated fact is thus material if it would have been viewed by a reasonable investor as having altered the "total mix" of information available. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Between March 1999 and May 2002, Donner issued 25 research reports that are the subject of Counts one and two of the Complaint.[11] The 25 Donner research reports were issued through a process in which the initial drafts were completed by a freelance writer, Richard M, who had no prior experience conducting research on publicly traded companies.[12] (Tr. II 304). Mr. M stated that he did not understand what a "going concern" opinion was, and testified that he never included disclosure about "going concern" opinions in any reports for Donner. (Tr. II 325). Mr. M worked from templates provided by Donner, company websites, and public filings on the SEC's website, but he clarified that he

[11] The reports covered the following firms: (1) Dynamic Web Enterprises, Inc. issued March 22, 1999 ("Dynamic"); (2) General Automation, Inc. issued June 7, 1999 ("General Automation"); (3) Medical Science Systems, Inc. issued June 14, 1999 ("Medical Science"); (4) Imaging Technologies Corporation issued June 23, 1999 ("Imaging Tech"); (5) ALYN Corporation issued July 7, 1999 ("ALYN"); (6) eSynch Corporation issued September 27, 1999 ("eSynch Corporation"); (7) Hawaiian Natural Water Co., Inc. issued October 5, 1999 ("Hawaiian Natural"); (8) American Champion Entertainment, Inc. issued October 18, 1999 ("American Champion"); (9) StarBase Corporation issued October 21, 1999 ("StarBase"); (10) Imperial Petroleum, Inc. issued November 11, 1999 ("Imperial"); (11) Professional Transportation Group Ltd., Inc. issued January 17, 2000 ("Professional Transport"); (12) Dippy Foods, Inc. issued January 31, 2000 ("Dippy"); (13) Ocean Power Corporation issued February 23, 2000 ("Ocean Power"); (14) iLive, Inc. issued March 8, 2000 ("iLive"); (15) Itronics Inc. issued March 20, 2000 ("Itronics"); (16) Genius Products, Inc. issued April 25, 2000 ("Genius Products"); (17) InsiderStreet.com, Inc. issued April 26, 2000 ("Insider"); (18) Pen Interconnect Inc. issued May 23, 2000 ("Pen"); (19) Advanced Biotherapy Concepts, Inc. issued August 21, 2000 ("Biotherapy"); (20) Far East Ventures, Inc. issued January 10, 2001 ("Far East"); (21) SEDONA Corporation issued April 25, 2001 ("Sedona"); (22) Aethlon Medical, Inc. issued June 12, 2001 ("Aethlon"); (23) Advanced Aerodynamics and Structures, Inc. issued June 27, 2001 ("Aerodynamics"); (24) Vital Living, Inc. issued April 24, 2002 ("Vital Living"); and (25) Xechem International, Inc. issued May 16, 2002 ("Xechem").

[12] Mr. M actually prepared over 200 research reports at Donner; he otherwise had no affiliation with Donner. (Tr. II 312).

only used the SEC's website "as a last resort. If I could find absolutely no other information." (Tr. II 307, 315).

Mr. M described the template that Donner gave him as having an overall positive tone. (Tr. II 305, 326-327). Mr. M rarely spoke with anyone from the subject companies, and he did not interview customers, test any of their products or investigate their competitors. (Tr. II 315-316, 325).

When a research report was issued, the Firm would issue a press release. (Tr. II 106). The press release contained a toll free number to contact the Firm for more information or to obtain a copy of the report. (Tr. II 107-108). The Firm distributed the research reports through its website, or by sending them to potential investors, following a "cold call," or in response to interest generated by a press release.[13] (*Id.*). Donner's written supervisory procedures manuals from 1999[14] and 2001[15] stated that research reports are considered to be sales literature. (Tr. II 380-381, 383-384). Accordingly, the Hearing Panel finds that the above written research reports were communications with the public that were subject to NASD Conduct Rule 2210.[16]

Each of the 25 research reports included a "buy" or "speculative buy" recommendation allegedly because the company was "highly undervalued," "poised for growth," "lacked

[13] Indeed, Enforcement presented evidence that Donner's website had 11,000 hits in December 1999 and compiled a roster of 7,000 individual investors. (CX-NC-80-b, at 16).

[14] CX-NC-11.

[15] CX-NC-12.

[16] *See also DOE v. Pacific On-Line Trading & Securities, Inc.*, 2002 NASD Discip. LEXIS 19, at *12 (NAC Nov. 27, 2002) (determining that sales literature posted to a public website is encompassed under and subject to the requirements of NASD Conduct Rule 2210).

competition," and had a "product or service in demand."[17] This information was not consistent with the negative information disclosed in public filings of the companies with the Securities and Exchange Commission ("SEC"). During the relevant time period, each of the subject companies filed reports with the SEC that stated that its independent auditor had expressed doubt as to whether the subject company would be able to continue as a going concern, i.e., a "going concern opinion."

The 25 research reports failed to disclose that going concern opinions had been issued for each company.[18] The 25 research reports also failed to disclose the underlying basis for the issuance of the going concern opinions, such as: aggregate net losses;[19] significant operating losses;[20] defaults on payment obligations;[21] reliance on short-term borrowing and issuance of

[17] CX-NC-18, at 1, 6, 9; CX-NC-19, at 1, 8; CX-NC-19a, at 1, 9; CX-NC-19b, at 1, 7; CX-NC-20, at 1, 9; CX-NC-20a, at 1, 9; CX-NC-21, at 11; CX-NC-22, at 1, 9; CX-NC-23, at 10; CX-NC-24, at 1, 6-7; CX-NC-25, at 1, 9; CX-NC-26, at 1, 9; CX-NC-26a, at 1, 9; CX-NC-27, at 1, 7; CX-NC-28, at 1; CX-NC-29, at 1; CX-NC-30, at 1, 10; CX-NC-31, at 1, 6; CX-NC-32, at 1, 9; CX-NC-33, at 1, 7; CX-NC-34, at 1-2, 6; CX-NC-35a, at 1, 4; CX-NC-36, at 2-8; CX-NC-37, at 1, 3, 6; CX-NC-38, at 1, 5, 9; CX-NC-39, at 1, 6-7; CX-NC-40, at 1-2, 9; CX-NC-41, at 1, 9; CX-NC-42, at 1, 10-11.

[18] CX-NC-18b, at 26; CX-NC-19d, at 33, 35; CX-NC-20d, at 38; CX-NC-21c, at 6-7; CX-NC-22b, at 30; CX-NC-23b, at 15; CX-NC-24b, at 22; CX-NC-25b, at 32-33; CX-NC-26c, at 25; CX-NC-27b, at 27; CX-NC-28c, at 30; CX-NC-29c, at 22; CX-NC-30b, at 20; CX-NC-31b, at 24; CX-NC-32b, at 36; CX-NC-33b, at 26; CX-NC-34b, at 15; CX-NC-35c, at 24; CX-NC-36b, at 23; CX-NC-37b, at 20; CX-NC-38b, at 14-15; CX-NC-39b, at 17; CX-NC-40b, at 21; CX-NC-41b, at 19; CX-NC-42b, at 32.

[19] CX-NC-18b, at 26, 33; CX-NC-21d, at 6; CX-NC-22b, at 16; CX-NC-22c, at 12; CX-NC-23b, at 11, 17, 19, 30; CX-NC-24b, at 16; CX-NC-25b, at 10; CX-NC-25c, at 14; CX-NC-27b, at 33; CX-NC-28b, at 43; CX-NC-31c, at 29; CX-NC-32b, at 29; CX-NC-32c, at 10; CX-NC-35c, at 6; CX-NC-35d, at 16; CX-NC-36c, at 27; CX-NC-37c, at 12; CX-NC-40b, at 5, 30; CX-NC-41b, at 16.

[20] CX-NC-18b, at 12; CX-NC-19d, at 5; CX-NC-20d, at 16; CX-NC-23c, at 13; CX-NC-26c, at 17, 37; CX-NC-27c, at 19; CX-NC-38b, at 19; CX-NC-39b, at 25; CX-NC-41b, at 17; CX-NC-42b, at 23.

[21] CX-NC-19d, at 6; CX-NC-40c, at 5.

stock for capital;[22] lack of adequate working capital;[23] accumulated deficits;[24] unlikelihood of generating revenues or profits;[25] illiquidity;[26] pending lawsuits that could materially impact the company;[27] limited operating history;[28] competition from better-established companies;[29] development-stage status;[30] and reliance on key customers.[31]

The Hearing Panel finds that the going concern opinions and the underlying reasons for those opinions were material facts that should have been disclosed because a reasonable investor would want to know such facts before investing in a company.[32]

In addition, by omitting the above negative material facts, the statements in the 25 research reports that depicted these companies as poised for unchallenged success or as emerging leaders in their industries were exaggerated, misleading, and false. For example, the Medical

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[22] CX-NC-23c, at 13; CX-NC-24c, at 16-17; CX-NC-25b, at 12; CX-NC-26c, at 37; CX-NC-27c, at 19; CX-NC-28d, at 8; CX-NC-33b, at 11-12, 24; CX-NC-34c, at 10; CX-NC-35g, at 15; CX-NC-41b, at 16-17.

[23] CX-NC-18b, at 26, 33; CX-NC-19d, at 18-19; CX-NC-19e, at 8; CX-NC-21d, at 6; CX-NC-22b, at 17; CX-NC-23b, at 12; CX-NC-23c, at 13; CX-NC-27b, at 24, 27, 33; CX-NC-27c, at 18-19; CX-NC-28d, at 8; CX-NC-29c, at 22; CX-NC-35c, at 6; CX-NC-36c, at 5; CX-NC-41b, at 16; CX-NC-42b, at 24.

[24] CX-NC-20d, at 16; CX-NC-22c, at 4; CX-NC-23c, at 4; CX-NC-25c, at 4; CX-NC-26e, at 6-7; CX-NC-27b, at 33; CX-NC-29c, at 22; CX-NC-30b, at 22; CX-NC-32c, at 5; CX-NC-35d, at 6; CX-NC-36b, at 24, 30; CX-NC-36c, at 6, 13; CX-NC-39b, at 20; CX-NC-39c, at 5; CX-NC-42b, at 23-24.

[25] CX-NC-18b, at 11-12; CX-NC-19d, at 5; CX-NC-20d, at 16; CX-NC-22b, at 16; CX-NC-22c, at 12; CX-NC-24c, at 8; CX-NC-26c, at 17; CX-NC-27b, at 27; CX-NC-34b, at 24; CX-NC-35c, at 6; CX-NC-36b, at 24, 30; CX-NC-40b, at 5, 30; CX-NC-40c, at 6; CX-NC-42b, at 24.

[26] CX-NC-19d, at 18-19; CX-NC-31c, at 13.

[27] CX-NC-32b, at 26.

[28] CX-NC-22b, at 16; CX-NC-29c, at 22; CX-NC-30b, at 16; CX-NC-41c, at 9; CX-NC-42b, at 24.

[29] CX-NC-19d, at 7; CX-NC-20d, at 13, 15; CX-NC-22b, at 12; CX-NC-24b, at 10-11; CX-NC-25b, at 6; CX-NC-28c, at 14; CX-NC-30b, at 8-9; CX-NC-31c, at 13; CX-NC-32b, at 18; CX-NC-33b, at 10-11; CX-NC-34b, at 7; CX-NC-36b, at 13; CX-NC-40c, at 8; CX-NC-42b, at 19-20.

[30] CX-NC-31b, at 5, 8, CX-NC-31c, at 4-5; CX-NC-34c, at 6; CX-NC-36c, at 13, 26; CX-NC-42b, at 23-24.

[31] CX-NC-21c, at 6-7; CX-NC-28c, at 9; CX-NC-34c, at 11.

[32] *See Riedel v. Acutote of Colorado LLP*, 773 F. Supp. 1055, 1063 (S.D. Ohio 1991) ("[A] company's 'financial condition, solvency, and profitability' [are] clearly material."); *Charles E. French*, 52 S.E.C. 858, 863 n.19 (1996)

(holding that one cannot successfully challenge the materiality of information about the financial condition, solvency, and profitability of the entity responsible for the success or failure of an enterprise).

Science research report states, "Medical Science Systems has made significant investments in building the infrastructure necessary to dominate in the field of genetic susceptibility testing for common, chronic, treatable diseases."[33] The company's SEC filings, however, state that "Competitors of the Company in the United States and abroad are numerous and include, among others, major pharmaceutical and diagnostic companies . . . Many of the Company's other potential competitors have considerably greater financial, technical, marketing and other resources than the Company, which may allow these competitors to discover important genes in advance of the Company."[34]

Additionally, the Dynamic research report states, "On February 16, 1999 the Company reported revenue for the fiscal first quarter ended December 31, 1998 of $540,000, a 223 percent increase of revenue of $167,000 reported for the same quarter in 1997."[35] Dynamic's SEC filings, however, state "Dynamic Web has been engaged in the electronic commerce business since only March of 1996. We have lost money every quarter since that time. . . . We cannot give assurances that we will soon make a profit or if we will ever make a profit."[36]

The Insider research report states, "We believe InsiderStreet.com Inc. is well on its way to becoming a leader in the rapidly emerging industry supporting essential communications between public companies and the investment community over the Internet."[37] Whereas the SEC filings for Insider state, "There are literally thousands of 'blank check' companies engaged in endeavors similar to those engaged in by the Company; many of these companies have substantial current assets and cash

[33] CX-NC-20, at 1.

[34] CX-NC-20d, at 13.

[35] CX-NC-18, at 6.

[36] CX-NC-18b, at 11.

[37] CX-NC-34, at 6.

reserves. . . the Company, having virtually no assets or cash reserves, will no doubt be at a competitive disadvantage in competing with entities which have recently completed IPO's, have significant cash resources and have operating histories when compared with the complete lack of any substantive operations by the Company."[38]

Donner, Baclet, and Uberti argued that the negative financial information contained in a company's periodic filings with the SEC was publicly available and thus the research reports did not have to specifically disclose it. (Tr. II 704-705). The Hearing Panel does not agree. The SEC has held that a registered representative may be disciplined under the NASD's rules for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to the customers.[39] Member firms and registered representatives have an affirmative obligation of fair dealing under NASD's rules; the mere fact that information is contained in regulatory filings does not justify the omission of material information in breach of this obligation.[40] Advertisements and sales literature must be judged in "the context of" the information provided in the advertisement or sales literature itself.

The Hearing Panel finds that the research reports failed to meet NASD Conduct Rule 2210's requirements that they be fair, objective and not misleading to the public when the reports emphasized the promising attributes of the subject companies without also disclosing the negative financial information available in the SEC filings. In addition, the omission of the negative financial information in combination with the positive forecasts for the companies

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[38] CX-NC-34b, at 7.

[39] *See Larry Ira Klein*, 52 S.E.C. 1030, 1036 (1996) ("Klein's delivery of a prospectus to Towster does not excuse his failure to inform her fully of the risks of the investment package he proposed").

[40] *Sheen Financial Resources*, Exchange Act Rel. 35477, 1995 SEC LEXIS 613 (Mar. 13, 1995) (Defects in advertisements cannot be cured through subsequent detailed explanations. Advertisements must stand on their own.).

constituted material omissions and exaggerated, misleading, and false statements.[41] Further, by violating NASD Conduct Rule 2210, Donner, Baclet, and Uberti also violated NASD Conduct Rule 2110's requirement that members and associated persons observe high standards of commercial honor and just and equitable principles of trade.

Accordingly, the Hearing Panel finds that Donner violated NASD Conduct Rules 2210 and 2110 by issuing 25 misleading research reports as alleged in counts one and two of the Complaint.

b. Baclet and Uberti Share Responsibility for the Misleading Research Reports

(i) Baclet Approved the Issuance of the Misleading Reports

Enforcement argued that Baclet, as the president of Donner, was responsible for the issuance by Donner of the misleading research reports. Baclet argued that the process of preparing the research reports was a "team effort" between Donner and the subject company, and he reasonably relied on the information that he received from the company. (Tr. II 866). In addition, Baclet argued that he did not personally review the research reports, and he reasonably relied on his staff to insure that the research reports complied with the rules. (Tr. II 749).

It is well settled that presidents of securities firms bear a heavy responsibility to ensure that their broker-dealers comply with all applicable rules and regulations unless and until they reasonably delegate

[41] Donner, Baclet, and Uberti argued that there was no evidence that any customers relied on the statements in the 25 research reports to their detriment. However, disciplinary proceedings are instituted to protect the public interest, not to redress private wrongs, and to find a violation of NASD Conduct Rule 2210, it is unnecessary to show customers relied on the material omissions or the misleading statements. *See, e.g., Wall Street West, Inc. v. SEC*, 718 F.2d 973, 1983 U.S. App. LEXIS 16129 (Oct. 12, 1983). Further, whether Donner, Baclet, and Uberti intended to disseminate misleading research reports is irrelevant, because intent is not required to establish violations of the sales literature rules. *Dep't of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17 (NAC June 25, 2001).

that function to another person in the firm.[42] In response to a request from the NASD staff to identify those individuals who worked on each research report, Baclet presented a document to the NASD staff dated November 11, 2001, on which he was listed as one of the persons who reviewed the listed research reports for supervisory purposes, including the 25 research reports listed in the Complaint.[43] Baclet retained the ultimate decision as to whether to release the 25 research reports, and he controlled the timing of the corresponding press releases. (Tr. II 106). The Hearing Panel finds that Baclet failed to demonstrate that he had reasonably delegated the ultimate responsibility for reviewing the research reports to another person in the firm.

The Hearing Panel also rejects Baclet's argument that he should not be found liable because he believed, in good faith, that the representations made in the research reports were truthful based on his reasonable reliance on the representations of the particular company's management. First, intent is not required to establish a violation of NASD Conduct Rules 2210 and 2110, and second, Baclet should have been aware of the omitted information concerning the companies' going concern opinions and the reasons for those opinions because the information was contained in the companies' public filings.

The Hearing Panel finds that Baclet shared the responsibility for providing misleading communications to the public and therefore Baclet violated NASD Conduct Rules 2210 and 2110 with respect to the Donner research reports.

[42] *See Hutchison Financial Corporation*, 51 S.E.C. 398 (1993).

[43] Tr. II 368-370; CX-NC-9.

(ii) Uberti Participated in the Review of the Misleading Reports

Counts one and two of the Complaint allege that Uberti was responsible for 22 of the 25 research reports. It is undisputed that Uberti participated in the review of those 22 research reports.

While Uberti was employed at Donner, Mr. M submitted his draft research reports to Uberti, who was his contact person at Donner. (Tr. II 102, 317). Uberti reviewed and edited Mr. M's work, added recent news to the reports, and was responsible for verifying the accuracy of the limited financial information that was included in the research report. (Tr. II 127-128, 547-548, 621-623, 733-735). Uberti also reassigned work from other research analysts to Mr. M. (Tr. II 72-74, 129).

Uberti maintained throughout the hearing that he performed only administrative functions at Donner, but that assertion is contradicted by evidence of his involvement in the research report process, his solicitation of new business, and his oversight of Mr. M. As a matter of law, Uberti, as a general securities representative, is presumed to know and understand the NASD Rules.[44] Because Uberti reviewed the 22 research reports before they were issued, he had the opportunity to ascertain whether the research reports met the sales literature requirements, but he failed to do so.

The Hearing Panel finds that Uberti shared the responsibility for providing misleading communications to the public and therefore Uberti violated NASD Conduct Rules 2210 and 2110 with respect to 22 of the 25 Donner research reports.

[44] *Carter v. SEC*, 726 F.2d, 472, 474 (9th Cir. 1983).

2. Count Three: Misleading Research Reports Issued with Scienter by Donner, Baclet, and Uberti

Count three of the Complaint alleges that the material omissions and misstatements, which violated the sales literature rules in counts one and two of the Complaint, also violated the fraud provisions of Section 10(b) of the Exchange Act,[45] Rule 10b-5 thereunder,[46] and NASD Conduct Rules 2120[47] and 2110.[48]

In order to find a violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Conduct Rule 2120, there must be a showing that: (1) misrepresentations and/or omissions were made; (2) the misrepresentations and/or omissions were material; (3) the misrepresentations and/or omissions were made with requisite intent, i.e., scienter; and (4) the misrepresentations and/or omissions were made in connection with the purchase or sale of securities.[49]

As discussed above, the Hearing Panel finds that omissions and misleading statements were made in the 25 research reports, and that those omissions and misleading statements were material.

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[45] Section 10(b) of the Exchange Act provides, "It [is] 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."

[46] SEC Rule 10b-5 provides, "It [is] unlawful for any person . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading . . . ."

[47] NASD Conduct Rule 2120 provides, "No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." *See also Dist. Bus. Conduct Comm. v. Euripides*, 1997 NASD Discip. LEXIS 45, at *18 (NBCC July 28, 1997).

[48] *See Ramiro Jose Sugranes*, Exchange Act Rel. No. 35,311, 1995 SEC LEXIS 234, at **3-4 (Feb. 1, 1995). *See also Stephen J. Gluckman*, 1999 SEC LEXIS 1395, at *22 (July 20, 1999) (finding that a violation of Rule 10b-5 or NASD Conduct Rule 2120, constitutes a violation of NASD Conduct Rule 2110).

[49] For Section 10(b) of the Exchange Act and SEC Rule 10b-5 thereunder, the transactions must also involve interstate commerce or the mails, or a national securities exchange. Donner, Baclet, and Uberti used a means and instrumentality of interstate commerce when they communicated with the customers, the companies, and the public via telephone and U.S. mail service. *See SEC v. Hasho*, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992), 1992 U.S. Dist. LEXIS 1322 at **148-149 (S.D.N.Y. Feb. 14, 1992).

Sales literature may meet the "in the connection with" requirement for purposes of satisfying Exchange Act Section 10(b).[50] It has already been established that the research reports at issue in this case were sales literature. The Hearing Panel finds that Donner generated the research reports in order to assist the subject companies to entice investors. Accordingly, the Hearing Panel finds that the misstatements and omissions were made "in connection with the purchase or sale of securities."

Scienter is the only remaining requirement needed to establish fraud. Scienter requires proof that a respondent intended to deceive, manipulate, or defraud,[51] or that he acted with recklessness.[52] Recklessness has been defined as highly unreasonable conduct involving not merely simple or excusable negligence, but an extreme departure from the standards of ordinary care that presents a danger of misleading buyers or sellers, which is either known to the defendant or is so obvious that the defendant must have been aware of it.[53] Recklessness is a mental state different from negligence and akin to conscious disregard.[54]

a. *Donner and Baclet Liable for Fraud*

As Donner's president and sole proprietor, Baclet had an obligation to ensure the Firm's compliance with all securities laws and regulations, including those pertaining to fraud. Although Donner's written supervisory procedures for 1999 and 2001 list Baclet as the individual with primary responsibility for the research reports, Baclet admitted that he did not

[50] *See, e.g., In re Carter-Wallace, Inc. Securities Litigation*, 150 F.3d 153 (2d Cir. 1998).

[51] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

[52] *Hollinger v. Titan Capital Corp*., 914 F.2d 1564 (9th Cir. 1990).

[53] *Tuchman v. DSC Communications Corp*., 14 F.3d 1061, 1067 (5th Cir. 1994), 1994 U.S. App. LEXIS 3326 at **14 (1994).

[54] *In re: Comshare, Incorporated*, 183 F.3d 542, 550 (6th Cir. 1999), 1999 U.S. App. LEXIS 15068 at **21 (1999).

review the final products before he released them for distribution. (Tr. II 382, 384, 986-987). Baclet's failure to review the final products under those circumstances was such an extreme departure from the standards of ordinary care that it constitutes recklessness. Based on the testimony of Baclet, the Hearing Panel finds that Baclet's conduct encompassed a mental state akin to conscious disregard. The Hearing Panel notes that Baclet had been a registered representative for about nine years when the first misleading research reports were issued. Baclet was also the only registered principal at Donner designated to review the research reports.[55] Baclet's failure to review the research reports was particularly egregious because, although he knew that the legal and compliance personnel at Donner were unregistered, unlicensed, and thereby unreliable to perform compliance reviews of the reports, he instructed Uberti to follow the direction of the legal and compliance personnel at Donner with regard to information to be included in the research reports.[56]

Accordingly, the Hearing Panel finds that Donner and Baclet violated the fraud provisions of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.

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[55] The last research report that Uberti assisted in issuing was dated June 27, 2001. Uberti did not become a registered principal of Donner until July 17, 2001. (CX-3, at 5).

[56] Uberti would get a draft report from Mr. M, edit it for accuracy and style, submit it to Brett Sadler ("Sadler") for compliance review, incorporate any of Sadler's edits, incorporate any recent developments, and then send it to Baclet before it was issued. (Tr. II 734, 749, 755). Baclet confirmed that, although Sadler had taken the necessary examinations two or three times, Sadler was not NASD registered at the time that he was employed by Donner. (Tr. II 954). In addition, although Sadler had completed law school at the time that he was at Donner, he had not passed the bar. (Tr. II 758, 886).

Baclet also admitted that, in June 1999, Donner hired a compliance consultant who warned the Firm that Sadler needed to be registered and that he needed to read the NASD rules and get himself organized. (Tr. II 954-956). Sadler remained unregistered throughout his employment with Donner, which ended in 2001. Three other people in Donner's legal department were not NASD registered, and two of those three people were not lawyers. (Tr. II 886-888).

b. Uberti Liable for Fraud

As discussed above, recklessness has been defined as highly unreasonable conduct involving not merely simple or excusable negligence, but an extreme departure from the standards of ordinary care that presents a danger of misleading buyers or sellers, which is either known to the defendant or is so obvious that the defendant must have been aware of it. Uberti, as a registered representative for more than four years, should have been aware that the information in the research reports that he reviewed was so obviously one-sided that it was misleading. Uberti's failure to recognize that a reasonable investor would consider negative financial information as material in making an investment decision was reckless.

For these reasons, the Hearing Panel finds that Uberti acted with the requisite scienter, and accordingly, he violated the fraud provisions of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.

3. Count Four: Donner Research Reports Omitted Compensation Disclosure

Count four of the Complaint alleges that the research reports issued by Donner for 51 companies failed to disclose that Donner had received compensation from the companies for preparing and disseminating the reports. The Complaint charges that Donner's failure, through Baclet and Uberti, to disclose the compensation it received violated NASD Conduct Rule 2110.

Donner received compensation for issuing research reports for the 51 companies. Under the terms of the "investment banking agreements" with the subject companies, Donner, in exchange for securities, products,[57] or monetary compensation, prepared and distributed research reports that gave

[57] Former research analyst, Tony Rhee, explained that they received, among other things, silver bars and computer equipment. (Tr. II 66).

favorable forecasts of the companies' performance and recommended that prospective investors purchase stock in the subject companies. (Tr. II 65). In addition to a retainer fee and maintenance fee, the Firm would also receive stock in the subject company as the stock price reached certain levels. (Tr. II 67). Baclet confirmed being paid in stock and/or cash, or both, for research that his company performed.[58] (Tr. II 883).

The 51 companies covered by the reports included 15 of the companies covered by the 25 research reports discussed above,[59] as well as 36 other companies.[60]

Section 17(b) of the Securities Act of 1933 makes it unlawful for any person "by use of any means or instruments of transportation or communication in interstate commerce or by use of the mails

[58] The Firm, under Baclet, also conducted cold calling to find potential investors for the companies for whom they prepared research reports and with whom they entered into investment banking contracts. (Tr. II 64-65, 67).

[59] These were: (1) Dynamic; (2) General Automation; (3) Medical Science; (4) Imaging Tech; (5) ALYN; (6) eSynch Corporation; (7) Hawaiian Natural; (8) American Champion; (9) StarBase; (10) Dippy; (11) Ocean Power; (12) iLive; (13) Itronics; (14) Genius Products; and (15) Pen. The following additional research reports were issued for these companies: (1) reports for General Automation issued on October 8, 1999 and January 25, 2000; (2) a report for Medical Science issued on July 12, 1999; (3) a report for StarBase issued on December 16, 1999; (4) reports for Dippy issued on February 8, 2000 and March 27, 2000; and (5) a report for Pen issued on September 21, 1999.

[60] These companies and reports were: (1) a report for Abaxis, Inc. issued May 4, 1999; (2) a report for Avcorp Industries issued June 7, 1999; (3) a report for B2 Technologies issued March 6, 2000; (4) a report for Carbite Golf issued September 13, 1999; (5) a report for China Premium Food Corp. issued February 8, 2000; (6) a report for Comanche Energy, Inc. issued October 27, 1999; (7) two reports for Cypros Pharmaceuticals Corp. issued April 2, 1999 and July 23, 1999; (8) a report for Datametrics Corporation issued August 23, 1999; (9) a report for Digital Power issued July 28, 1999; (10) two reports for Discovery Laboratories, Inc. issued November 30, 1999 and April 10, 2000; (11) a report for Diversified Senior Services issued December 16, 1999; (12) a report for Genetronics issued June 16, 1999; (13) a report for Geo2 Limited issued October 21, 1999; (14) a report for Incubator Capital issued February 7, 2000; (15) a report for Integrated Spatial Information Solutions, Inc. issued March 6, 2000; (16) a report for Interleukin Genetics issued March 8, 2000; (17) a report for InternetStudios.com, Inc. issued March 2, 2000; (18) a report for Lancer Orthodontics issued April 19, 1999; (19) a report for Longport, Inc. issued February 2, 2000; (20) a report for Media Bay, Inc. issued March 9, 2000; (21) two reports for Mustang Software, Inc. issued September 21, 1999 and February 22, 2000; (22) a report for ObjectSoft Corp. issued September 13, 1999; (23) a report for Orlando Predators Entertainment, Inc. issued February 22, 2000; (24) a report for PharmaPrint, Inc. issued July 23, 1999; (25) two reports for Pioneer Behavioral Health, Inc. issued May 5, 1999 and June 21, 1999; (26) a report for PLC Systems, Inc. issued April 24, 2000; (27) a report for PriceNet USA, Inc. issued March 7, 2000; (28) a report for Retrospettiva, Inc. issued February 23, 2000; (29) three reports for SVI Holdings issued September 9, 1999, February 17, 2000 and September 26, 2000; (30) a report for Titan Pharmaceuticals, Inc. issued June 22, 1999; (31) a report for Tri-Lite, Inc. issued October 19, 1999; (32) three reports for Trimedyne, Inc. issued July 27, 1999, February 28, 2000 and April 4, 2000; (33) a report for TrimFast Group, Inc. issued March 7, 2000; (34) a report for WaveRider Communications, Inc. issued February 8,

to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, through not purporting to offer a security for sale, describes such security for consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective of such consideration and the amount thereof."

It is undisputed that the research reports were communications describing securities for sale, and that the research reports did not disclose Donner's receipt of compensation and the amount thereof in compliance with Section 17(b) of the Securities Act of 1933. It is well settled that any conduct that violates the securities laws and regulations or NASD rules also violates NASD Conduct Rule 2110. Therefore, the Hearing Panel finds that Donner violated NASD Conduct Rule 2110 by issuing research reports in violation of Section 17(b) of the Securities Act of 1933.

The Hearing Panel also finds that Baclet, as the president of Donner and the person who negotiated the compensation arrangements with the companies, was responsible for the Firm's violations of Section 17(b), and therefore Baclet violated NASD Conduct Rule 2110. (Tr. II 67-68).

The Hearing Panel also finds that Uberti, as a registered representative who participated in the review of the research reports for 44 of the 51 companies before they were issued, also violated NASD Conduct Rule 2110 because he knew that Donner had received compensation for the reports, and he knew that the compensation information was not included in the reports.[61]

2000; (35) two reports for Xybernaut Corporation issued October 12, 1999 and January 24, 2000; and (36) a report for Zapworld.com issued February 23, 2000.

[61] Donner, Baclet, and Uberti argued that research reports issued by other companies did not disclose compensation received by the companies. Even assuming that other firms violated Section 17(b), misconduct by others would not excuse the misconduct of Donner, Baclet, and Uberti.

4. Count Five: Donner Research Reports Violated NASD Conduct Rule 2110

Count five of the Complaint alleges that Donner, Baclet, and Uberti violated NASD Conduct Rule 2110 by: (i) omitting the existence of the "going concern" opinions in the 25 research reports; (ii) including exaggerated, misleading, and false statements in the same 25 research reports; and (iii) failing to disclose that Donner received compensation for the preparation and dissemination of the research reports for 51 companies.

As explained above, the Hearing Panel has determined that Donner, Baclet, and Uberti violated NASD rules and the securities laws by omitting the existence of the "going concern" opinions in the 25 research reports, by including exaggerated, misleading, and false statements in the same 25 research reports, and by failing to disclose that Donner received compensation for the preparation and dissemination of the research reports for 51 companies.

It is well settled that any conduct that violates the federal securities laws and/or the NASD Conduct Rules is viewed as a violation of NASD Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations.[62] Accordingly, the Hearing Panel finds that the above misconduct of Donner, Baclet, and Uberti is a violation of NASD Conduct Rule 2110.

5. Count Six: Donner Principal Failed to Note Approval of Research Reports

Count six of the Complaint alleges that Donner and Baclet failed to have the research reports signed by a principal of the Firm, in violation of NASD Conduct Rules 2210(b)(1) and 2110. NASD Conduct Rule 2210(b)(1) provided that a registered principal of the member must

[62] *Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12-*13 (NAC June 2, 2000).

approve by signature or initial each advertisement and item of sales literature before its use.[63] As explained above, the research reports issued by Donner constituted sales literature.

Although Baclet controlled the research report process, was a principal of the Firm, and was designated as the person in charge of advertising, he could not recall who, if anyone, initialed the reports. (Tr. II 943, 947-950). Baclet admitted that he only thoroughly read 10 to 15 of the research reports issued between 1999 and 2000, and did not review the final products before they were distributed. (Tr. II 986-987). Donner issued the reports without Baclet's signature and approval, as principal.[64] (Tr. II 947).

Accordingly, the Hearing Panel finds that Donner and Baclet violated NASD Conduct Rule 2210(b)(1) by failing to have a principal approve the research reports, and by violating that rule they also violated NASD Conduct Rule 2110.

6. Count Seven: Donner Failed to Establish Adequate Supervisory Procedures

Count seven of the Complaint alleges that Donner and Baclet failed to establish and maintain written supervisory procedures pertaining to the preparation and dissemination of the Firm's research reports, in violation of NASD Conduct Rules 3010 and 2110.

Conduct Rule 3010 provides that each member shall establish, maintain, and enforce written procedures to supervise the types of businesses in which it engages, and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of NASD.

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[63] *NASD Notice to Members 98-93*.

[64] Although NASD Conduct Rule 2210(b)(2) required that all advertisements and sales literature be maintained in a separate file for three years, hard copies of the final approved research reports were not kept in any one particular location. (Tr. II 109-110).

The Firm had no supervisory procedures in place to ensure that its research reports were issued in accordance with the securities laws and regulations. (Tr. II 109-110). Baclet confirmed that the written supervisory procedures contained no guidance on preparing research reports. (Tr. II 109, 942-943). Baclet testified about a "worksheet" of procedures, but as he described the document, it provided no specific information about how to establish that due diligence on a company had been completed. (Tr. II 873-874). In fact, when presented with one sample worksheet, Baclet confirmed that the worksheet was primarily concerned with Donner's fee for its services, and it represented a chronology of work for, and interaction with, the client. (Tr. II 929-933).

The people actually drafting the research reports had little guidance. Mr. Rhee received no training on how to write research reports; he learned from looking at other companies' reports. (Tr. II 58-59). Runyon learned how to approach prospective clients "through exposure"; he did not have any formal training. (Tr. II 564, 567). Likewise, Uberti did not have a written supervisory procedures manual while employed with Donner, and he never saw written supervisory procedures for the preparation and dissemination of research reports, nor received guidance on how to ensure that the reports did not contain any unwarranted or exaggerated statements. (Tr. II 753-755).

Finally, although the written supervisory procedures for 1999 and 2001 listed Baclet as the individual with primary responsibility for the research reports, Baclet testified that he only reviewed 10 to 15 of the research reports. Consequently, in addition to failing to provide adequate supervisory procedures to ensure compliance with the NASD conduct rules, Baclet failed to comply with the inadequate limited procedures that he had put in place at Donner. (Tr. II 986-987).

Accordingly, the Hearing Panel finds that Donner and Baclet failed to establish and maintain written supervisory procedures pertaining to the preparation and dissemination of the Firm's research reports, in violation of NASD Conduct Rules 3010 and 2110.

D. The Lincoln Research Reports

When Uberti left Donner, he and Runyon became registered with NASD member firm Lloyd and formed Lincoln, a non-NASD member firm, of which they each owned 50%. While at Lincoln, Uberti and Runyon equally shared responsibility for conducting the same type of research report activity as was being performed at Donner. Uberti and Runyon relied on Lloyd for their NASD registration and for compliance review. Uberti and Runyon referred potential investors who were interested in purchasing the stock of the companies that were the subject of their research reports to Lloyd to execute the transactions. (Tr. 216).

The Complaint specifically pertains to two research reports Lincoln issued in 2001 for companies that had little or no trading volume and whose independent auditors had issued going concern opinions.

1. Background

Runyon testified that he and Uberti would issue research reports only for companies that they believed deserved a favorable report. For example, he emphasized that they would not write research reports for companies in the "pink sheets." (Tr. 432, 563-564). Runyon explained that he and Uberti had discussions with potential clients about aspects of their businesses that the potential clients needed to change before he and Uberti were willing to issue a positive report recommending the stock of the company. (Tr. 469-473).

Once they decided they would issue a report, Uberti and Runyon referred the assignment to Mr. M, the same freelance writer who had prepared reports for Donner. The Donner reports were his only experience conducting research on publicly traded companies. (Tr. 45-47). Uberti hired Mr. M because of his journalistic abilities; he was unconcerned with Mr. M's lack of financial background. (Tr. 249). Mr. M did not understand what a going concern opinion was, and testified that he never included any reference to such opinions in any reports for Lincoln. (Tr. 53). Furthermore, he testified, "I really don't understand everything about it . . . I couldn't tell a good company from a bad company." (Tr. 64).

Mr. M prepared his drafts using a template that he received from Uberti and Runyon, which included text that had an "overall positive" tone. Mr. M never visited or spoke with anyone from the subject companies, nor did he interview their customers, test any of their products, or investigate their competitors. (Tr. 50-51). Neither Uberti nor Runyon ever asked him to conduct more extensive research, and he was never instructed what information to obtain and review. (Tr. 51, 68-69).

Uberti himself also conducted "due diligence" for subject companies, which basically consisted of searching the internet, reviewing the company's periodic SEC filings spanning approximately a two-year period, and evaluating information provided by the company itself, like press releases, if available. (Tr. 273-275, 345-346).

2. Counts Eight and Nine: The Majestic and Dtomi Research Reports Were Misleading

Count eight of the Complaint alleges that Uberti and Runyon, as registered representatives of Lloyd, violated NASD Conduct Rules 2210(d)(1)(A) and 2110 by failing to disclose material negative financial information about the companies, Majestic and Dtomi. Count nine of the Complaint alleges

that Respondents Uberti and Runyon violated NASD Conduct Rules 2210(d)(1)(B) and 2110 by including exaggerated and misleading information about Majestic and Dtomi in their research reports.

Runyon and Uberti announced a completed research report via press release on the PR Newswire. (Tr. 204-205). A potential investor could contact Lincoln for more information or to obtain a copy of the report, or could obtain the report from Lincoln's website, after supplying certain basic personal information.[65] (Tr. 118-119, 204-205). The Hearing Panel therefore finds that the Majestic and Dtomi research reports were "sales literature,"[66] and thus were subject to the requirements of NASD Conduct Rule 2210 pertaining to communications with the public that such communications be fair, objective, and not misleading. As discussed above, the case law is clear that advertisements and sales literature are to be judged in "the context of" material provided in the advertisement or sales literature itself.

It is undisputed that during the relevant time, Majestic and Dtomi had each filed reports with the SEC stating that its independent auditor had issued a going concern opinion. The two research reports issued by Uberti and Runyon for Majestic and Dtomi failed to disclose the going concern opinions, and failed to disclose the underlying reasons for the opinions.[67] Furthermore, the two research reports recommended the purchase of Majestic and Dtomi stock, and contained a very positive description of each company's prospects, suggesting a likely rapid appreciation of the stock, which was in direct conflict with the negative information disclosed in public filings.[68] The reports falsely claimed that the

[65] Runyon testified on May 8, 2002 at an on-the-record interview with NASD that about 1,000 people had registered on the website. *See also* Tr. 225.

[66] NASD Conduct Rule 2210 regulates communications with customers and the public. Subpart (a) states that "sales literature" is one of the categories of communications covered by the rule, and it includes "research reports."

[67] CX-LE-15b, at 28; CX-LE-16b, at 14.

[68] CX-LE-15, at 11; CX-LE-16, at 10.

two companies were "well positioned" for growth,[69] had "upside potential,"[70] or touted baseless, expected boosts in earnings.[71]

Therefore, the Hearing Panel finds that the Majestic and Dtomi research reports failed to present an accurate and balanced picture of the risks and benefits of investing in those companies, as required under NASD Conduct Rule 2210.

As discussed above, a reasonable investor would certainly consider information relating to a company's financial condition and profitability as being relevant to his decision to purchase or sell that company's stock.[72] In this case, the research reports not only lacked any strong indication of a negative outlook for each subject company, but they contained exaggerations of each company's realistic capabilities of becoming profitable.

Uberti and Runyon argued that because it was obvious that the company was not a blue-chip company because it traded on the bulletin board and was considered "speculative," a reasonable investor would not simply rely on the research report but would do his own due diligence.[73] Arguing that the negative financial information should have been evident to anyone investing in a penny stock, Uberti and Runyon argued that a going concern opinion or disclosure

[69] CX-LE-16, at 1, 5, 9-10; CX-LE-15, at 1, 11.

[70] CX-LE-15, at 1.

[71] CX-LE-16, at 6-8.

[72] Contrary to Runyon's argument that a "going concern opinion" is an opinion and therefore cannot be a material fact, the Hearing Panel finds that the existence of the opinion is a material fact that a reasonable investor would consider important in determining whether to make the investment. (Tr. 442).

[73] Tr. 379-380.

of other negative financial information did not need to be included in the actual research report.[74] Uberti testified that he does not believe that a going concern clause is material because the audience for penny stock reports is comprised of sophisticated, accredited investors, and it is obvious to such an investor that companies that issue penny stocks may not be able to continue operations. (Tr. 199, 201). Uberti and Runyon contended that they genuinely believed that information about the negative features of the companies was irrelevant to a sophisticated investor. However, Uberti and Runyon had no way of ensuring that only accredited investors had access to their website at Lincoln. (Tr. 220). They incorrectly asserted that only accredited investors could purchase penny stocks. (Tr. 199). In fact, any investor may purchase such stocks. Runyon also testified that he and Uberti were under the strong impression that only sophisticated investors could purchase speculative stocks because their broker would have to determine that the stocks were suitable for them. (Tr. 434-435). A broker's suitability obligation, however, generally extends only to investments that the broker recommends. Consequently, the customer's broker will not necessarily prevent or provide additional due diligence for a customer who has determined to purchase a security based on research reports that are incomplete and therefore misleading.

Finally, and even assuming that Uberti and Runyon were correct that sophisticated and accredited investors routinely engage in additional due diligence, sophisticated and accredited investors

[74] Mr. Runyon believed it was not necessary to explicitly disclose the negative financial information because a reasonable investor would know that the financial information for an OTCBB company was negative. He argued, "A reasonable investor assumes that the company is in dire financial straights. If there is an assumption to be made, it would certainly be to the negative and not to the positive; otherwise the company wouldn't be where it is, on the bulletin board." (Tr. 21). Mr. Runyon further stated, "The information requirements of a penny stock buyer are different than that of a national buyer. No reasonable penny stock buyer looks at a company that is trading at 2 ½ cents with brackets around its bottom line and assumes that the company is flush with cash and that there is [sic] no operational problems." (Tr. 20). "The entire report speaks caution from the nature of its rating as a speculative buy issue to its posting of 'OTCBB' after the name and the symbol." (Tr. 30).

are still entitled to receive investment information that is complete, accurate, and not misleading. Research reports are required to present an accurate and balanced picture of the risks and benefits of a particular investment. Disclosing only the positive aspects of the investment while assuming that the investor is sufficiently sophisticated to ascertain the negative aspects of the investment on his own is not acceptable conduct for a registered individual.

The material omissions and misstatements in the two Lincoln research reports did not provide investors and potential investors with accurate and balanced information upon which they could fairly evaluate the risks and benefits of investing in the subject companies. The Hearing Panel finds that Uberti and Runyon therefore violated NASD Conduct Rules 2210 and 2110.

3. Count Ten: The Two Lincoln Research Reports were Fraudulent

Count ten of the Complaint alleges that Respondents Uberti and Runyon violated the fraud provisions of Section 10b of the Exchange Act, SEC Rule 10b-5 thereunder, and NASD Conduct Rule 2120 by failing to disclose the material negative financial information, and by including exaggerated and misleading statements, in the Majestic and Dtomi research reports.

As discussed above, in order to find a violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Conduct Rule 2120, there must be a showing that: (1) misrepresentations and/or omissions were made; (2) the misrepresentations and/or omissions were material; (3) the misrepresentations and/or omissions were made with requisite intent, i.e., scienter; and (4) the misrepresentations and/or omissions were made in connection with the purchase or sale of securities.

Scienter requires poof that a respondent intended to deceive, manipulate, or defraud,[75] or that he acted with severe recklessness involving an extreme departure from the standards of ordinary care.[76]

The Hearing Panel finds that the misstatements and omissions in the research reports were instrumental in generating sales in securities. Accordingly, the Hearing Panel finds that the misstatements and omissions were material and were made "in connection with the purchase or sale of securities."

The Hearing Panel credits the testimony of Uberti and Runyon that they mistakenly believed that only sophisticated investors would be able to purchase Majestic and Dtomi stock, and that those investors would be aware that a Bulletin Board listed company, by its very nature, was likely to be a risky investment with a negative financial history and questionable earnings potential.

In addition, Lincoln submitted the research reports to Lloyd's compliance department for review before the reports were posted on Lloyd's website. (Tr. 31-32). Uberti and Runyon understood that Lloyd's compliance department served as gatekeeper for anything posted to the Lincoln website.[77] As a result, Uberti stated that he and Runyon believed Lloyd was responsible for ensuring that the reports complied with the advertising rules.

However, Uberti also acknowledged that he and Runyon, as registered individuals, had an obligation to prepare reports that were fair and not misleading. Uberti and Runyon knew that the reports did not provide all material information. Specifically, they knew that the research reports did not provide certain negative information that an investor would want to know when making

[75] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

[76] *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990).

[77] Tr. 406-407, 436-437.

an investment decision.

Under these circumstances, the Hearing Panel finds that Uberti and Runyon should have known that it was not appropriate to present only the favorable information when making a recommendation that a customer purchase an investment, and therefore their actions were reckless and constituted fraud.

Accordingly, the Hearing Panel finds that Respondents Uberti and Runyon violated Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and NASD Conduct Rule 2120 as alleged in count ten of the Complaint.

4. Count Eleven: Lincoln Research Reports Violated Conduct Rule 2110

Count eleven of the Complaint alleges that Respondents Uberti and Runyon violated NASD Conduct Rule 2110 because of their failure to disclose the material negative financial information alleged in count eight of the Complaint, and the inclusion of the exaggerated and misleading statements alleged in count nine of the Complaint, in the Majestic and Dtomi research reports.

NASD Conduct Rule 2110 states, "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." It is well settled that any conduct that violates the securities laws and regulations or NASD rules also violates NASD Conduct Rule 2110.

In counts eight and nine of the Complaint, the Hearing Panel has already determined that Uberti and Runyon violated NASD Conduct Rule 2210(d) by omitting the existence of the "going concern" opinions in the two Lincoln research reports, and by including exaggerated, misleading, and false statements in the same two research reports. Accordingly, the Hearing Panel also finds that the above misconduct of Uberti and Runyon is a violation of NASD Conduct Rule 2110.

III. Sanctions

Because the Respondents' violations at their respective firms all arose from a single course of conduct related to their preparation and distribution of research reports, Enforcement proposed a single set of sanctions for each Respondent as appropriate and effective to achieve NASD's remedial goals. The Hearing Panel agrees that is appropriate in this case.[78]

A. Donner Research Reports: Donner, Baclet, and Uberti

The NASD Sanction Guidelines for misrepresentations or material omissions of fact recommend a fine of $10,000 to $100,000 for intentional or reckless misconduct.[79] Additionally, the Guidelines recommend a suspension of the individual in any or all capacities and of the firm for a period of 10 business days to two years, or a bar or expulsion in egregious cases. The Guidelines for intentional or reckless use of misleading communications to the public also recommend a fine of $10,000 to $100,000, and a bar or expulsion in cases of numerous acts of intentional or reckless misconduct over an extended period of time.[80]

Enforcement argued that this was an egregious case warranting a bar for Baclet and Uberti, and an expulsion for Donner because of: (i) the nature of the information that was omitted from the research reports; (ii) the exaggerated statements contained in the research reports; (iii) the number of misleading research reports; (iv) the widespread dissemination of the misleading information; and (v) the intentional misconduct alleged in counts one through five of the Complaint.

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[78] *See, e.g., Dep't of Enforcement v. Respondent Firm 1*, No. C8A990071, 2001 NASD Discip. LEXIS 6, at **30-31 (NAC Apr. 19, 2001).

[79] *NASD Sanction Guidelines*, p. 96 (2001).

[80] *Id*. at 89.

The Hearing Panel agrees that the conduct of Donner and Baclet was egregious. In particular, the nature of the information omitted, the number of misleading reports, and the substantial period of time over which the misconduct in counts one, two, and four of the Complaint occurred warrants serious sanctions.

The intentional or reckless nature of the misconduct of Donner and Baclet, as alleged in count three of the Complaint, also supports a finding that the conduct was egregious. The egregious nature of the misconduct is further evidenced by the violations in count six and seven of the Complaint, which involve the failure to approve the research reports and the failure to establish a supervisory procedure to govern the reports.[81]

Baclet provided no evidence that he now understands his responsibilities as an NASD registered individual, especially as a registered principal. Although he continues to assert that the research reports were not misleading, Baclet testified that as of the time of the hearing, almost a year after he received the initial Complaint, he still had not bothered to read all of the research reports at issue. Baclet's continued failure to acknowledge any responsibility for the misconduct indicates to the Hearing Panel that Baclet is a danger to the investing public. Baclet completely failed to understand or perform his responsibilities as the president of Donner. Baclet and Donner presented no mitigating circumstances that would warrant less than a bar of Baclet and an expulsion of the Firm from the industry.

The Hearing Panel finds that Uberti's misconduct also warrants a serious sanction considering: (i) the nature of the omitted information and the exaggerated information; (ii) Uberti's role in reviewing

the research reports; (iii) the number of research reports; and (iv) the period of time during which the research reports were issued.

However, the Hearing Panel finds as a mitigating factor that Uberti relied on Baclet's final review of the research report for conformity with the securities laws and NASD rules. Uberti's reliance on Baclet's review was reasonable because: (i) Baclet was the only registered principal involved in the review process; (ii) Baclet had been in the securities industry twice as long as Uberti; and (iii) Baclet appeared to be reviewing the research reports. Uberti also believed that Donner had previously cleared the format of the research reports, including the reference to the SEC website, with the regulatory authorities. In addition, Uberti expressed remorse and testified that he would not make the same mistakes in the future. Based on his demeanor, the Hearing Panel finds Uberti to be credible, and finds that the imposition of a suspension and a fine would be sufficient to deter any future misconduct.

Accordingly, for recklessly disseminating false and misleading research reports, as alleged in counts one through five of the Complaint, Donner is expelled and Baclet is barred in all capacities. In light of the bar and the expulsion, no fines are imposed and no separate sanctions are imposed on Donner and Baclet for the failure to note a principal's approval of the research reports and failure to establish adequate supervisory procedures, as alleged in counts six and seven of the Complaint. The Hearing Panel concludes that for Uberti a two-year suspension in all capacities and a $20,000 fine are appropriate sanctions for his reckless participation in the dissemination of false and misleading reports as alleged in counts one through five of the Complaint.

B. Lincoln Research Reports: Runyon and Uberti

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[81] For failing to obtain signed approval for the research reports, the relevant guideline states that an adjudicator should consider fining the responsible person $1,000 to $20,000, and suspending him or her in any or all capacities for

With respect to the two Lincoln Research reports, Enforcement argued that Runyon and Uberti, as registered representatives with Lloyd, were equally responsible, and recommended the same sanction for both individuals. Enforcement recommended that Runyon and Uberti each be suspended for six months and fined $50,000, and each be ordered to requalify as both a general securities representative and as a general securities principal.

As discussed above, the NASD Sanction Guidelines for misrepresentations or material omissions of fact recommend a fine of $10,000 to $100,000 for intentional or reckless misconduct. Taking into consideration the serious nature of the information that was omitted, but also considering that there were only two research reports and that the reports were submitted to Lloyd prior to issuance, the Hearing Panel finds that Runyon and Uberti each should be suspended for six months from associating with any member firm in any capacity, each fined $20,000, payable upon re-entry into the industry, and each ordered to requalify as both a general securities representative and as a general securities principal.

IV. Conclusion

Therefore, the Hearing Panel: (1) expels Respondent Donner Corporation International (N.K.A. National Capital Securities, Inc.) from NASD membership for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and Conduct Rules 2120, 2210, and 2110, by recklessly issuing misleading research reports; (2) bars Respondent Jeffrey L. Baclet from associating with any NASD member firm in any capacity for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2210, and 2110, by recklessly issuing misleading research reports; (3) suspends Respondent Vincent M. Uberti from

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up to 60 days. (*Guidelines* at 88.)

associating with any member firm in any capacity for two years and fines him $20,000 (due and payable when or if Uberti seeks to return to the securities industry) for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and Conduct Rules 2120, 2210, and 2110, by participating in the issuance of the misleading Donner research reports; (4) suspends Uberti from associating with any member firm in any capacity for an additional six months, fines him an additional $20,000 (due and payable when or if Uberti seeks to return to the securities industry), and orders him to requalify as both a general securities representative and as a general securities principal for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2210, and 2110, by issuing two misleading Lincoln research reports; and (5) suspends Respondent Paul A. Runyon from associating with any member firm in any capacity for six months, fines him $20,000 (due and payable when or if Runyon seeks to return to the securities industry), and orders him to requalify as both a general securities representative and as a general securities principal for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2210, and 2110, by issuing two misleading Lincoln research reports. In light of the expulsion and bar, no additional sanctions are imposed on Donner and Baclet for violating the supervision requirements set forth in Conduct Rules 3010 and 2110.

In addition, with respect to the $13,881.69 costs of the hearing, which include an administrative fee of $750 and hearing transcript costs of $13,131.69, the Hearing Panel orders: (1) Donner and

Baclet jointly and severally to pay $6,331.72 of the costs; (2) Uberti to pay $5,090.12 of the costs; and (3) Runyon to pay $2,459.85 of the costs.[82]

These sanctions shall become effective on a date set by NASD, but not earlier than 30 days after the date this decision becomes the final disciplinary decision of NASD, except that if this decision becomes NASD's final disciplinary action, Baclet's bar and Donner's expulsion will become effective immediately, Uberti's 30-month suspension will become effective with the opening of business on Monday, August 2, 2004 and end at the close of business on February 1, 2007, and Runyon's six-month suspension shall become effective with the opening of business on Monday, August 2, 2004 and end at the close of business on February 1, 2005.[83]

HEARING PANEL

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by: Sharon Witherspoon
Hearing Officer

Dated: June 7, 2004
Washington, DC

Copies to:
National Capital Securities, Inc. (formerly Donner Corporation International)
(via Federal Express and first class mail)
Jeffrey L. Baclet (via Federal Express and first class mail)
Vincent M. Uberti (via Federal Express and first class mail)
Paul A. Runyon (via Federal Express and first class mail)
Gary A. Carleton, Esq. (via electronic and first class mail)
Edward G. Rosenblatt, Esq. (via electronic and first class mail)
Rory C. Flynn, Esq. (via electronic and first class mail)

[82] The $750 administrative fee was divided equally among the four Respondents. Runyon and Uberti were charged each one half of the Phase I transcript costs, and Donner, Baclet, and Uberti were charged with approximately one third of the Phase II transcript costs.

[83] 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.