NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. HERBERT I. KAY (CRD No. 1374570) 3242 E. ARROYO CHICO TUCSON, AZ 85716, Respondent.	Disciplinary Proceeding No. C3A030015 Hearing Officer – DRP **DECISION** July 13, 2004

Respondent is barred for participating in private securities transactions without giving prior written notice to the NASD member firm with which he was associated, in violation of NASD Conduct Rules 3040 and 2110.

Appearances

For the Department of Enforcement: Roger Hogoboom, Assistant Chief Litigation Counsel, Denver, CO (Rory C. Flynn, Esq., Washington, DC, Of Counsel).

For the Respondent: Armand Salese, Esq., Salese & McCarthy, P.C., Tucson, AZ.

DECISION

I. Procedural History

The Department of Enforcement filed a one-count Complaint on May 20, 2003, charging that Herbert I. Kay (Kay or Respondent) violated NASD Conduct Rules 3040 and 2110 by engaging in private securities transactions without providing his employer with prior written notice. Kay filed an Answer on July 8, 2003, in which he denied the charge and requested a hearing. On February 23, 2004, a one-day hearing was held in Tucson, before a hearing panel composed of the Hearing Officer and two current members of District Committee 3.

At the commencement of the hearing, Respondent admitted all allegations in the Complaint. Enforcement briefly questioned Respondent, then moved for summary disposition pursuant to NASD Procedural Rule 9264. The Hearing Panel granted Enforcement's motion, which Respondent did not oppose, because there was no genuine issue of material fact and Enforcement was entitled to summary disposition as a matter of law.

Thus, the only remaining issue at the hearing was the sanction to be imposed. Enforcement offered nineteen exhibits, which were admitted in evidence, and the Respondent testified on his own behalf.[1] On March 19, 2004, the parties filed post-hearing briefs.

II. Findings of Fact and Conclusions of Law

A. Jurisdiction

Kay was registered with NASD member Linsco/Private Ledger Corporation (LPL) as a general securities representative and general securities principal from March 16, 1995 until his registration was terminated on December 20, 2000. He is currently registered with another member firm.[2]

B. Amigos offering

On March 3, 2000, Respondent co-founded (with MS) Amigos Investment I, L.L.C. (Amigos), an Arizona limited liability company, in order to acquire an interest in, and develop for residential use, approximately 10 acres in Puerto Penasco, Sonora, Mexico. On March 8, 2000, Amigos commenced a private placement of securities, offering equity ownership in the

[1] References to the hearing transcript are noted as Tr. Enforcement's exhibits are cited as CX; Respondent did not offer any exhibits.

[2] CX-1. Respondent is subject to NASD jurisdiction, because he was registered with a member firm at the time of the alleged violation and when Enforcement filed the Complaint.

form of 250 to 400 units, at a cost of $10,000 per unit, with a minimum investment of $50,000. (CX-2, pp. 1, 8.)

Once acquired, title to the property was to be held by a Mexican company that Respondent and MS owned. Though Respondent and MS had no experience developing or managing commercial real estate, the property was to be developed, marketed and sold by two other Mexican companies that Respondent and MS also owned. Respondent and MS were to receive as compensation an “organization and acquisition fee” of $300,000, a monthly property management fee of $16,667.67, and five percent commission from the sale of each townhouse built on the property. The investment involved a “high degree” of risk, there was no market for the units, and Respondent and MS stood to make substantial profits even if the project were unsuccessful. All of this information was disclosed in the private placement memorandum. (CX-2, pp. 1, 8, 9, 14, 15, 16, 17.)

From March to May 2000, Respondent sold 290 units to 24 investors, raising a total of $2.9 million. All but two investors were LPL customers whose accounts were handled by Respondent. Respondent admits he did not provide written notice to LPL regarding the Amigos offering, but until the morning of the hearing, claimed he had verbally informed his firm of the selling activity. At the hearing, he recanted and admitted he had never informed LPL that he was soliciting customers to invest in Amigos and had lied to NASD throughout the investigation. (Tr. 13, 25, 43-48; CX-3, CX-4, CX-5, CX-7, CX-8.)

Once LPL discovered Respondent’s involvement with Amigos, the firm instructed Respondent to return all money to the investors.[3] After Respondent complied with this directive, his employment with LPL was terminated. Respondent testified that he received no

[3] After learning of Kay’s involvement in Amigos from another broker-dealer, LPL conducted a surprise audit of Respondent’s office. No records regarding Amigos were found, but Respondent admitted that he had participated in the Amigos offering without notifying LPL. CX-9.

compensation from Amigos, and investors lost no money.[4] Respondent admitted to the Panel that he had made a mistake by failing to tell his firm about Amigos and conceded he took a "calculated risk" that LPL would not uncover his activity. (Tr. 13, 27-29; CX-9.)

C. Private Securities Transactions

NASD Conduct Rule 3040 prohibits an associated person from participating in private securities transactions ("selling away") without prior detailed written notice to his or her firm. Rule 3040 defines a "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission."

Where a broker may receive selling compensation, the member firm must respond to the notice in writing indicating whether it approves or disapproves of the person's participation in the proposed transaction. If the member approves the transaction, the member must record the transaction in its books and records and supervise the associated person's participation in the transaction as if the transaction had been executed by the member firm.

The SEC has explained why transactions concealed from a broker's employer are problematic:

> The regulatory scheme under the Exchange Act, in which the NASD is assigned a vital role, imposes on broker/dealer entities and NASD member firms the responsibility to exercise appropriate supervision over their personnel for the protection of investors. Where employees effect transactions for customers outside of the normal channels and without disclosure to the employer, the public is deprived of protection which it is entitled to expect. Moreover, the employer

[4] After he left LPL, Respondent moved to another member firm. He testified that he provided written notice to the new firm regarding Amigos, and 23 of the original 24 investors purchased units in the new offering. Respondent further testified that the project was then delayed for several reasons, including problems obtaining additional financing. To that end, Respondent, MS, and two others formed Sonoran Capital, a Mexican mortgage company modeled after the Ugly Duckling used car business, which Respondent described as taking a "non-traditional collateralized asset… underwrite the loans… securitize them, sell them out the back door, raise capital, leverage it, [then] do it again." Respondent reported that they were "beginning construction" on the property in late February 2004. Tr. 29-35, 50-51.

may also thus be exposed to risks to which it should not be exposed. Thus, such conduct is not only potentially harmful to public investors, but inconsistent with the obligation of an employee to serve his employer faithfully.

Anthony J. Amato, Exchange Act Rel. No. 10265, 1973 SEC LEXIS 2769, at **6-7 (June 29, 1973) (footnotes omitted).

Respondent acknowledges he violated Rule 3040, and the record abundantly supports his concession. There is no dispute that the investments in Amigos involved securities or that Respondent participated in the sales. Respondent conceded that he gave no written notice to his firm prior to engaging in these transactions.

The Panel finds, and Respondent concedes, that he participated in private securities transactions involving the sale of Amigos. The Panel concludes that he did so without first giving his firm detailed written notice of his intended participation. Respondent thus violated Rule 3040. Such misconduct also constitutes a violation of NASD Conduct Rule 2110, which requires the observance of high standards of commercial honor and just and equitable principles of trade.[5]

III. Sanctions

NASD Sanction Guidelines for selling away were revised late last year.[6] In addition to slightly modifying the five principal considerations in the previous Guideline, eight new factors were added. For selling away, the Guidelines recommend a fine of $5,000 to $50,000, with suspensions that vary in length according to the dollar amount of sales. Here, where the amount is above $1,000,000, the Guidelines recommend a suspension of twelve months to a bar, a period that can be increased or decreased based on aggravating or mitigating factors.

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[5] *See Stephen J. Gluckman*, Exchange Act Release No. 41,628, 1999 SEC LEXIS 1395, *22 (July 20, 1999)(citations omitted).

[6] NASD Special Notice to Members 03-65 (Oct. 2003). The changes became effective on December 1, 2003, and applied to all actions as of that date, including pending disciplinary actions.

In addition to the dollar amount of sales, adjudicators are to consider twelve other factors when determining sanctions in selling away cases: (1) number of customers; (2) length of time over which the selling away activity occurred; (3) whether the product has been found violative of federal or state securities laws or federal, state or SRO rules; (4) whether respondent had a proprietary or beneficial interest in or was otherwise affiliated with, the selling enterprise or issuer, and, if so, whether respondent disclosed this information to his customers; (5) whether the respondent attempted to create the impression that his employer sanctioned the activity; (6) whether respondent's selling away activity resulted, either directly or indirectly, in injury to the investing public and, if so, the nature and extent of the injury; (7) whether respondent sold away to customers of his or her employer; (8) whether respondent provided the member firm with verbal notice of the details of the proposed transaction and, if so, the firm's verbal or written response, if any; (9) whether respondent sold the securities after the member firm instructed him or her not to sell the product at issue; (10) whether respondent participated in the sale by referring customers or selling the product directly to customers; (11) whether respondent recruited other registered individuals to sell the product; and (12) whether respondent misled his employer about the existence of the selling away activity or otherwise concealed the selling away activity from the firm.[7]

In this case, the thirteen factors present a mix of circumstances. Kay's misconduct occurred over a relatively short period of time. No adjudicator has found that the Amigos offering violated any other laws. There is no evidence that Kay attempted to create the impression that his firm backed the activity, or that he recruited other registered persons to sell the product. Most importantly, no losses were incurred by investors; however, this may have been due to LPL's insistence that Kay refund all the money he had collected.

[7] Id. at 678-679.

Most of the principal considerations weigh against Respondent. As noted, the total dollar amount involved in the selling away ($2.9 million) was significant. Kay unquestionably had a proprietary or beneficial interest in the issuer. He served as co-founder and co-manager of Amigos, as well as co-owner of the three Mexican entities responsible for purchasing, developing and selling the land, though this information was disclosed in the private placement memorandum. He sold to twenty-four investors; all but two were customers of LPL. Respondent participated in the sales directly by soliciting customers. In some instances, he sold securities in a customer's LPL account in order to fund the purchase of his Amigos venture, which may have posed a conflict of interest.

Respondent claimed throughout the investigation and this proceeding -- until the morning of the hearing -- that he had told LPL's president about the Amigos sales, a conversation that the president denied having.[8] Respondent finally admitted to the Panel that he had lied, and he had not, in fact, provided his firm with verbal notice of details regarding Amigos. He acknowledged that he hid the activity from the firm and took a "calculated risk" that LPL would not discover his selling away. He declared that he had made a "stupid calculation" that Amigos would "never come to light" but agreed there is "no mitigating factor," because he "knew what [he] was doing."[9]

Enforcement contends that a bar is warranted, because Respondent completely disregarded fundamental standards of ethics, integrity and honesty expected of professionals in the securities industry. Respondent argues for a less severe sanction and points to cases in which respondents received a short suspension and a fine, while attempting to distinguish those cases in

[8] CX-10, CX-11.

[9] Tr. 49.

which respondents were barred.[10] Respondent stresses that he accepted responsibility for his wrongdoing and expressed regret over the violations. He also emphasizes his "exemplary disciplinary record."[11]

The Panel has considered all of the above circumstances, as well as the parties' arguments, and notes that selling away is a serious breach of a registered representative's duty to the investing public and to his firm.[12] It is critically important that registered representatives comply with Rule 3040 to ensure that investors receive the protections to which they are entitled under the securities laws and regulations.

The Panel finds that Respondent's misconduct requires a serious sanction. There are several aggravating factors, including Respondent's false claim throughout the investigation that he had provided verbal notice to his firm of his private transactions. Moreover, Respondent had been previously advised that a similar deal was problematic, yet he chose to proceed with Amigos little more than a year later. In November 1998, Kay was told that he could not engage in a transaction with MS that involved buying land, building a nightclub on the property, and seeking investors, because it could be considered selling away.[13] Despite this warning from LPL, Respondent decided to pursue the Amigos offering in March 2000, then repeatedly lied by stating that he had provided his firm with verbal notice of his selling activity. Though it was

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[10] Appropriate sanctions depend on the facts and circumstances of a particular case and cannot be compared with disciplinary action taken in other proceedings. *Butz v. Glover Livestock Commission Co.*, 411 U.S. 182, 187 (1973)(other citations omitted). Furthermore, the cases cited by Respondent were decided under the prior Guidelines.

[11] The lack of a disciplinary history is not a mitigating factor. *See Dep't of Enforcement v. Balbirer*, Complaint No. C07980011, 1999 NASD Discip. LEXIS 29 (NAC Oct. 18, 1999).

[12] *Dep't of Enforcement v. Roger A. Hanson,* Complaint No. C8A000059, 2002 NASD Discip. LEXIS 5, at *14 (NAC March 28, 2002), *citing Dep't of Enforcement v. Fergus,* Complaint No. C8A990025, 2001 NASD Discip. LEXIS 3, at *66 (NAC May 17, 2001).

[13] CX-12.

certainly better that Respondent eventually admitted he had lied rather than perjure himself at the hearing, his last-minute candor does not serve as a mitigating factor.

Finally, Respondent, who was a principal and had supervisory responsibilities at LPL, utterly ignored his firm's very restrictive policy regarding selling away. LPL completely prohibited representatives from engaging in "activities that may be deemed to be private securities transactions or selling away," warning that any violation would be grounds for immediate dismissal.[14]

Respondent's misconduct was deliberate, motivated by his own financial gain, and without regard for NASD rules or his firm's policies. He then attempted to conceal his wrongdoing by lying about it. The Panel finds that a bar is warranted.

IV. Conclusion

Respondent Herbert I. Kay violated NASD Conduct Rules 3040 and 2110 by participating in the sale of securities issued by Amigos without prior written notice to the NASD member firm with which he was associated. For these violations, Respondent is permanently barred from association with any member firm in any capacity.[15] Respondent shall pay costs in the amount of $1,176.84, which includes an administrative fee of $750 and hearing transcript costs of $426.84.

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[14] CX-18, p. 3. It appears this policy was put in place in January 2000. When Respondent joined LPL in 1995, he received a copy of the firm's existing policy, which required written notification of and approval by LPL prior to any private securities transactions. CX-13.

[15] The Hearing Panel has considered all of the arguments of the parties. They are sustained or rejected to the extent they are in accord or inconsistent with the views expressed herein.

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

HEARING PANEL

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By: Dana R. Pisanelli
Hearing Officer

Dated: July 13, 2004
Washington, DC

Copies to: Herbert I. Kay (*via overnight and first class mail)*
Armand Salese, Esq. (*via facsimile and first class mail*)
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