BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 1 Complainant, vs. Respondent Firm 1 and Respondent 2 Respondents.	DECISION Complaint No. C01960018 District No. 1 Dated: April 7, 1999

Broker/dealer violated the rule that requires investors' funds in an "all-or-none" underwriting to be deposited in a trust or escrow account and made a misrepresentation to investors when it stated that a private placement was on an "all-or-none" basis but then expended customers' funds before the broker/dealer had sold all the units in the offering. Held, findings and sanctions affirmed as to firm but reversed as to individual respondent.

Respondent 2 has appealed the decision of the District Business Conduct Committee for District No. 1 ("DBCC"). This matter was also called for review as to Respondent Firm 1 and Respondent 2 pursuant to NASD Procedural Rule 9312.[1] After a review of the entire record in this matter, we affirm the findings of the DBCC that Respondent Firm 1 failed to establish properly an escrow account in connection with the contingency offering of units in a private placement and misrepresented to investors that their funds would be held in an escrow account. As to Respondent 2,

[1] We called this case for review to determine whether the sanctions imposed by the DBCC were appropriate in light of the findings of violation. We specifically indicated that we wanted to determine whether the respondents should pay restitution.

we reverse the findings of the DBCC that he committed the same violations as Respondent Firm 1, and we dismiss the allegations against him. As to Respondent Firm 1, we impose a censure, a $2,500 fine, and costs.

Background

From January 1995 to April 1997, Respondent Firm 1 was a member of the NASD. Respondent Firm 1 subsequently was dissolved.

Respondent 2 entered the securities industry in 1972 as a general securities representative. From 1985 to 1988, Respondent 2 was registered as a general securities representative of Firm B, which was a member of the NASD from 1985 to 1996. Respondent 2 was never registered with Respondent Firm 1 and he has not been registered in any capacity since 1988.

Facts

Firm B was formed for the purpose of marketing real estate syndications created by Respondent 2. Firm B was owned by Respondent 2 and two of his business associates, Respondent 2's Business Associates C (Business Associates C) and Respondent 2's Business Associates D (Business Associates D). Firm B was also known as and did business under a trade name. During the period relevant to this action, Respondent 2 was not registered in any capacity with Firm B. Business Associate C was the President of Firm B and was registered as a general securities principal of that firm. Business Associate D was also registered as a principal of Firm B. In the years before the conduct at issue here, Firm B had successfully sold approximately 40 real estate syndications created by Respondent 2.

During late 1994, Respondent 2, Business Associate D, and Business Associate C formed Respondent Firm 1. Respondent Firm 1 was formed exclusively to sell interests in Respondent 2's real estate syndications. Respondent 2 owned 100 percent of the stock of Respondent Firm 1 and he provided all of its capital. Respondent 2 selected Business Associate D as the sole director of Respondent Firm 1 and Business Associate D also served as Respondent Firm 1's President. Respondent 2 was not an officer, a director, or an employee of Respondent Firm 1. Respondent Firm 1 and Firm B shared offices in the same office space in State 1. Respondent 2's main office was in State 2, but he also had an office in the same shared office space in State 1.

In 1995, Respondent Firm 1 became a member of the NASD. In connection with its application for membership, the NASD required Respondent 2 -- who was not registered in any capacity with the NASD -- to execute a letter regarding his lack of participation in the daily operations of Respondent Firm 1. The letter stated that Respondent 2 would have "no involvement in the

management of Respondent Firm 1," that he would not "participate in any securities-related activities," and that he would not "share in commissions generated by Respondent Firm 1."

One reason for the formation of Respondent Firm 1 was its intended participation in the private placement of units of a real estate development named RE Development. RE Development was a limited liability company that was formed to purchase approximately 11 acres of land in State 3. RE Development planned to construct 228 upscale apartment homes in the Southeast Valley portion of the State 3 metropolitan area. The RE Development private placement consisted of 82 units being offered at a cash purchase price of $66,000 per unit.

Firm D, another Respondent 2-owned company but not an NASD member, served as RE Development's manager. Firm D was located in State 2 and Respondent 2 was its President. According to RE Development's private placement memorandum ("Offering Memorandum"), Firm D would "control all decisions concerning the management" of RE Development. The Offering Memorandum stated that a State 3site had already been purchased by RE Development. As to that land purchase, the Offering Memorandum stated, "The Managing Member [Firm D] and its affiliates have loaned the Company [RE Development] the necessary funds to purchase the Property at the interest rate of prime plus 1.5 percentage points per annum."

On December 12, 1994, Firm B and Firm D entered into a selling agreement concerning Firm B's proposed sale of units of RE Development. Business Associate D executed the agreement for Firm B and Respondent 2 signed it on behalf of Firm D.[2]

On February 21, 1995, Respondent Firm 1 and Firm D entered into a selling agreement concerning Respondent Firm 1's proposed sale of units of RE Development. Acting as President, Business Associate D signed the agreement on behalf of Respondent Firm 1 and Respondent 2 signed the agreement on behalf of Firm D.

Best Efforts Underwriting. The Offering Memorandum contained a section entitled "Terms of Offering" which stated:

> The closing date after which no further sale of Units will be made is April 28, 1995 unless extended without notice by the Manager. The Company has opened an interest bearing escrow account Bank A in State 1, which will receive and hold_proceeds of the Offering. The Offering may be withdrawn, in which case all funds will be returned to investors including any interest earned thereon.

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[2] Business Associate C, Business Associate D, and Firm B were named in the complaint in this case and subsequently settled the allegations of violations of Securities and Exchange Commission ("SEC") Rules 15c2-4 and 10b-9 and Conduct Rule 2110.

The first page of the Offering Memorandum stated that: "The Units are being offered on a best efforts, all or none basis."

During January 1995, sales of RE Development began through Firm B. Upon its activation, Respondent Firm 1 also sold RE Development units. From January 1995 through January 1996, Firm B and Respondent Firm 1 raised a total of $3,404,489 from the sale of RE Development units. RE Development's manager, Firm D, attempted to set up an escrow account for the investors' funds. Firm D's Comptroller, handled this task; he did not, however, deposit the funds into an escrow account at Bank A as was represented in the Offering Memorandum. Rather, he deposited them into a standard bank account with the caption "RE Development Escrow Account."

From February 1995 to the end of April 1995, Firm D released funds from the RE Development bank account. On eight different occasions, a total of $1,506,600 in investor funds was withdrawn from the account and was disbursed for, among other expenses, repaying the loans used to purchase the RE Development property.

An amended and restated RE Development private placement memorandum, dated June 27, 1995, extended the closing date of the offering to May 17, 1996. By this date, Respondent Firm 1 and Firm B had sold all the units to investors, and the offering closed.

Discussion

We find that Respondent Firm 1 violated SEC Rules 15c2-4 and 10b-9 as alleged in the complaint. We do not, however, find that Respondent 2 is liable for the violations of Respondent Firm 1 and its officers and employees. Accordingly, we dismiss the allegations against Respondent 2.

Respondent Firm 1 Violated SEC Rule 15c2-4 and Rule 10b-9. In response to our call for review as to Respondent Firm 1, we received no response from Respondent Firm 1. Respondent 2's attorneys in this proceeding have repeatedly stated that they do not represent Respondent Firm 1. Because Respondent Firm 1 has disputed none of the findings against it, we abbreviate our discussion and adopt by reference the DBCC's factual findings and conclusions as to Respondent Firm 1.

The RE Development private placement was on an "all-or-none" basis. The facts as to how the funds were handled, however, establish that investor funds were deposited into an ordinary checking account at a bank. From this account, Firm D withdrew the investors' funds before the contingencies of the offering were met and before the offering closed.

SEC Rule 15c2-4 provides that a broker or dealer who participates in an "all-or-none" underwriting and accepts the sale price of a security before all the represented contingencies are met must either deposit the investors' funds into a trust account for the benefit of investors or transmit the investors' funds to a bank that has established an escrow account.[3] If a broker or dealer fails to handle the investors' funds in the prescribed manner, the broker or dealer has committed a fraudulent, deceptive or manipulative act or practice. Id.

Respondent Firm 1 had planned to deposit investors' funds in an escrow account until all the units were sold. Respondent Firm 1's President testified, however, that the plan was not followed. Instead, through the actions of Comptroller at Firm D, the investors' funds were deposited in a non-escrow account, and more than one million dollars of the investors' funds were taken out of the account before the RE Development offering closed. Respondent Firm 1's failure to ensure that the funds were deposited in an escrow account violated SEC Rule 15c2-4. The fact that Firm D, not Respondent Firm 1, opened a non-escrow account is irrelevant to Respondent Firm 1's liability. SEC Rule 15c2-4 fixes liability on a broker/dealer when it accepts investor funds, which is what Respondent Firm 1 did. Accordingly, we affirm the DBCC's finding that Respondent Firm 1 violated SEC Rule 15c2-4 and Conduct Rule 2110.

SEC Rule 10b-9 prohibits any person from making a representation that a security is being offered on an "all-or-none" basis unless the amount due the investor is to be refunded if all of the securities being offered are not sold or the seller does not receive the total amount due by a specific date.[4] Here, Respondent Firm 1's failure to ensure that the investors' funds were not withdrawn rendered false the Offering Memorandum's representation that -- if the manager withdrew the offering -- "all funds [would] be returned to investors." Cf. SEC v. Electronics Warehouse, Inc., 689 F. Supp. 53, 62 (D. Conn. 1998), aff'd sub nom., SEC v. Calvo, 891 F.2d 457 (2d Cir. 1989), cert. denied, 496 U.S. 942 (1990). In fact, Firm D had already disbursed a large portion of the investors' funds. Given the fact that Respondent Firm 1 failed to verify that a proper escrow account was established and that it failed to notice that investors' funds were being disbursed from the bank account, we find that Respondent Firm 1 acted with scienter because its conduct was so "highly unreasonable" as to be reckless.[5] Accordingly, we affirm the DBCC's findings that Respondent Firm 1 violated SEC Rule 10b-9 and Conduct Rule 2110.

Respondent 2's Duty To Comply with SEC Rules 15c2-4 and 10b-9. As previously mentioned, Respondent 2's relationship with Respondent Firm 1 was that he owned 100 percent of the

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[3] See SEC Rule 15c2-4(b); 17 C.F.R. § 240.15c2-4 (1998).

[4] See Louis Loss and Joel Seligman, Securities Regulation vol. VIII at 3893 (3d ed. 1991.)

[5] See SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985); see also Hollinger v. Titan Capital Corp., 914 F. 2d 1564 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991); Sirota v. Solitron Devices, Inc., 673 F. 2d 566 (2d Cir.), cert. denied, 459 U.S. 838 (1982).

stock of this corporation. He was not an officer, director, or employee of Respondent Firm 1. Respondent 2 testified that he did not personally solicit any investor for the RE Development offering. In addition, we find that the record supports Respondent 2's statement that he was not engaged in the investment banking or securities business at the relevant time.

The SEC has repeatedly upheld the rule that the president of a broker/dealer is ultimately responsible for all compliance with the securities laws unless and until he reasonably delegates particular functions to another person and neither knows nor has reason to know that such person's performance is deficient. See In re Michael Ben Lavigne, Exchange Act Rel. No. 33951 (Apr. 21, 1994), aff'd, 78 F.3d 593 (9th Cir. 1996) (table case); In re Jerome H. Shapiro, 46 S.E.C. 472, 474 (1976).

In this case Respondent Firm 1's President, not Respondent 2, was responsible for ensuring that Respondent Firm 1 complied with the securities laws during the RE Development offering. We reject the DBCC's suggestion that a 100-percent stockowner necessarily has the same compliance responsibilities as a president of a broker/dealer. Because Respondent 2 was not an officer of Respondent Firm 1, had no compliance responsibilities at Respondent Firm 1, and did not sell any RE Development units, we find that he did not violate SEC Rules 15c2-4 and 10b-9 or Conduct Rule 2110. We also conclude, under the specific circumstances of this case, that Respondent 2 had no duty to ensure that Respondent Firm 1 complied with SEC Rules 15c2-4 and 10b-9 and Conduct Rule 2110.

In finding that Respondent 2 violated the rules at issue in this case, the DBCC also relied on the fact that Respondent 2 was President of Firm D. We find, however, that Respondent 2's activities as President of Firm D do not establish a violation of SEC Rules 15c2-4 and 10b-9. Respondent 2 and Business Associate C testified that they delegated to Firm D's Comptroller, the responsibility to set up the escrow account for RE Development. We find that Respondent 2 reasonably delegated this responsibility to The Comptroller. Consequently, we reverse the findings of the DBCC that Respondent 2 violated SEC Rules 15c2-4 and 10b-9 and Conduct Rule 2110. We dismiss causes one and two as to Respondent 2.

Sanctions

As to Respondent Firm 1, the DBCC imposed a censure and a $2,500 fine and assessed hearing costs. We affirm these sanctions.

The NASD Sanction Guidelines ("Guidelines") for escrow violations, including SEC Rules 15c2-4 and 10b-9, state that no suspension should be imposed on a broker/dealer "in cases involving no intentional scheme to circumvent the rules, no prior similar misconduct, one offering, and no overreaching."[6] All four of these circumstances are true in this case. We also find that no customers

[6] Guidelines (1996 ed.) at 19 (Escrow Violations). The recommended sanctions are consistent with the applicable Guideline.

were denied the return of their investment. The record shows that one customer canceled his purchase of a unit and his money was promptly returned. In light of all of these circumstances, we impose a $2,500 fine on Respondent Firm 1 as the appropriate level of fine to serve as a financial deterrent of similar misconduct.

We have also considered the issue of restitution. The Guidelines explain that "[w]hen harm to public customers is part of the violative activity, restitution is generally recommended where the customers are clearly identifiable."[7] Here, Respondent Firm 1 did not cause any monetary harm to its customers. Respondent Firm 1 and Firm B sold all of the RE Development units to investors, and the offering closed without the need for refunds. Under these circumstances, we do not find it appropriate to order restitution.

[7] Guidelines (1996 ed.) at 4.

Accordingly, Respondent Firm 1 is censured, fined $2,500, and assessed DBCC hearing costs of $1,289.10.[8]

On Behalf of the National Adjudicatory Council,

Alden S. Adkins, Senior Vice President and General Counsel

[8] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedure Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanctions, after seven day's notice in writing, will summarily be revoked for non-payment.