BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

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| In the Matter of<br><br>District Business Conduct Committee<br>For District No. 1,<br><br>Complainant,<br><br>vs.<br><br>Robin Bruce McNabb<br>San Jose, CA,<br><br>Respondent. | DECISION<br><br>Complaint No. C01970021<br><br>District No. 1<br><br>Dated: March 31, 1999 |

**Registered representative engaged in private securities transactions without informing his employer and recommended the purchase of securities to some of his customers without having reasonable grounds to believe that such securities were suitable for these customers. Held, DBCC's findings and sanctions affirmed in part, and modified in part.**

Respondent Robin Bruce McNabb ("McNabb") appealed the July 24, 1998 decision of the District Business Conduct Committee for District No. 1 ("DBCC") pursuant to Procedural Rule 9310. After a review of the entire record in this matter, we affirm the DBCC's findings that McNabb engaged in private securities transactions without informing his employer and recommended the purchase of securities to some customers without reasonable grounds for believing that the investments were suitable for them. We order that McNabb be censured, fined $50,000 and barred from association with any member of the NASD in any capacity.

## Background

McNabb first entered the securities business in 1981. From February 1990 through December 7, 1995, McNabb was employed by American Investors Company ("AIC"), a member of the NASD whose home office (the "Home Office") is in Hayward, California. McNabb was terminated from AIC on December 7, 1995. After he was terminated, he was employed by another member of the NASD until September 1997.[1] He was registered as a general securities principal until October 14, 1997. He remains subject to the jurisdiction of NASD Regulation, Inc. ("NASD Regulation") for purposes of this proceeding pursuant to Article IV, Section 6 of the NASD By-Laws.

Facts

During his tenure at AIC, McNabb was the manager of an AIC Office of Supervisory Jurisdiction in San Jose, California. He operated this office as an independent contractor under the name of RKM Financial Group ("RKM"). McNabb had a real estate broker's license, and he derived the bulk of his income from real estate transactions. He also derived revenue from sales of insurance and securities and from tax return preparation. Pursuant to AIC's written policies, transactions involving real estate investments, including transactions involving trust deeds, did not require written notification to, or the consent of, AIC.

On December 11, 1995, AIC filed with the NASD a Form U-5, which indicated that AIC had terminated McNabb on December 7, 1995 for violating AIC's policy against taking loans from customers. The Form U-5 also stated that McNabb had possibly violated NASD Conduct Rules 3030 and 3040, which prohibit an associated person from conducting outside business activities and engaging in private securities transactions.[2] This disciplinary action resulted from NASD Regulation's investigation of McNabb's termination from AIC.

NASD Regulation examiner Keith Kirk ("Kirk") conducted NASD Regulation's investigation of McNabb's termination from AIC. During his investigation, Kirk collected information from McNabb and Clarence Yee ("Yee"), vice president of AIC.

AIC Begins Its Investigation. AIC had scheduled a routine audit of RKM for December 7, 1995. Several days before the audit, AIC discovered information that prompted it to conduct an informal investigation of McNabb's activities.

On December 4, 1995, Cheryl Bauer ("Bauer"), the operations manager in the Home Office, received a phone call from Avis Erkel ("Erkel"), McNabb's assistant at RKM, who instructed Bauer to arrange the liquidation of class B mutual fund shares for customers JR and MR, a married couple. Bauer explained that she could not process the

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[1] McNabb informed his subsequent employer of the transactions that are the subject of this action, and his subsequent employer approved them.

[2] NASD Regulation ultimately charged McNabb with a violation of Conduct Rules 2310 (suitability) and 3040, but not Conduct Rule 3030.

sale until McNabb was able to confirm that JR and MR were aware of the deferred sales charge they would incur.[3] Erkel called Bauer back and told her that McNabb had informed JR and MR verbally of the charge. Employees at the Home Office were unsatisfied with the lack of details about the alleged notification, and they became suspicious about McNabb's activities.

Yee contacted JR and MR directly. MR initially told Yee that she was not aware of the charge, that she did not think that her husband was aware of the charge, and that she and her husband "had plans for the money through McNabb." In a subsequent conversation later that same day, MR told Yee to sell the shares. In response to Yee's inquiry about their plans for the money, MR told Yee that she and JR trusted McNabb and that their investment plan was none of Yee's business.

Bauer then phoned and asked Erkel to explain the investment that MR and JR were planning with McNabb. Erkel told Bauer that she could not respond without angering McNabb.

At Erkel's suggestion, Bauer contacted Jan Reynolds ("Reynolds"), a former RKM employee. Reynolds said that she too was concerned that if she responded, she could get into trouble with McNabb. She suggested that they check other McNabb customer accounts for similar liquidations. On that same day, Yee and Bauer examined McNabb's customers' statements and discovered the following: earlier that year, customer LM had withdrawn $209,500 from her account by writing a check for that amount to "Scavengers;"[4] customer RS had withdrawn $65,000 from her account; and customer VH had withdrawn $58,000 from his account.[5]

<u>AIC's Investigation of "Scavenger."</u> On December 5, 1995, Erkel told Bauer that she thought Scavenger was a venture that McNabb had organized. Erkel said that the name Scavenger appeared on asset statements for several of McNabb's customers and that

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[3] JR and MR had purchased these shares just three months earlier.

[4] At the time of this transaction, RKM had informed the Home Office that the liquidation was necessary due to LM's difficult financial situation.

[5] Later on December 4, McNabb called and informed Yee that MR and JR had phoned him about their conversation with Yee. McNabb said that MR and JR needed to liquidate their mutual fund shares in order to purchase a Winnebago. McNabb told Yee that MR and JR had been incorrect when they said they were planning to invest the funds through him. Two days later, on December 6, McNabb forwarded Yee a letter in which MR and JR assured Yee that they would not be "investing the monies with Rob McNabb in stocks, bonds, or mutual funds," but that they were going to use the money to purchase a recreational vehicle.

McNabb had a list of other customers to contact about Scavenger. Specifically, Erkel said that she had copies of signed agreements for customers PD and VH relating to their investments in Scavenger. She also said that she had recently seen a lease agreement that involved an investment by JR and MR in Scavenger. Erkel said that she and Bob Weeks ("Weeks"), McNabb's former certified public accountant at RKM, had asked McNabb about Scavenger several times, but McNabb had always denied its existence. Erkel said that McNabb's denials were contradicted by an application that she had seen for a bank account in the name of Scavenger and by checks McNabb had drawn on the Scavenger account. Bauer obtained from Reynolds the names of several other customers who were possibly involved in Scavenger. Bauer also contacted Weeks, who told her that he had quit his job at RKM after McNabb started the Scavenger venture and then denied it existed.

Yee then contacted several of McNabb's customers in an effort to obtain information about Scavenger. PD's wife told Yee that she and her husband had recently met with McNabb, but she would not tell Yee the reason for or substance of the meeting. The next day, on December 6, Erkel called Bauer and told her that PD had informed McNabb that AIC had contacted PD's wife about Scavenger. McNabb told Erkel that Scavenger did not exist and that Erkel should not mention it to anyone. According to Erkel, McNabb then began putting documents from client files in his office into his wastebasket. Erkel told Bauer that she had kept copies of the documents relating to Scavenger.

Yee next contacted LM, from whose account $209,500 had been transferred to Scavenger in May 1995. LM told Yee that she was unaware of both the $209,500 check and the investments McNabb had sold her, but that she completely trusted McNabb. She said that she usually reviewed her investments with McNabb at his office.

The Scavenger Account. Later that day, Erkel faxed Yee certain documents that purported to represent the promissory notes and equipment leases that comprised the Scavenger account. Staff for NASD Regulation District No. 1 (the "District") introduced these documents during the DBCC proceedings.

Customers HS and MS. According to a February 27, 1995 letter from McNabb to HS and MS, HS and MS sold their shares of the Keystone K-1 fund and used the $40,000 proceeds to purchase a promissory note from McNabb. HS and MS made out a check for $40,000 to Scavenger, and in return, they received interest at the rate of 12 percent per year. McNabb's letter concluded with the following: "[H] and [M], I am delighted to have you in SCAVENGER. Owing to the fact that I do want to protect your privacy, the envelope is addressed to my home address."[6]

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6 HS and MS subsequently entered into another promissory note for $35,000 with McNabb through Scavenger on April 12, 1995 at 12-percent interest.

Customers PD and FD. Similarly, a September 20, 1994 letter from McNabb to PD and FD detailed PD and FD's various assets: money market funds, mutual fund investments, equity investments and a Scavenger Note valued at $50,000.[7] The letter stated that PD and FD had written two checks to RKM for a total of $50,000, and that the current status of their Scavenger account was as follows: $15,000 placed; 14 percent interest; $2,000 in points due and payable at the maturation of placement; no scheduled due date, because the account was set to revolve; points would be paid on the project as received. The letter also stated that at the end of the year, PD and FD would receive a cumulative report on their Scavenger account, "which you should keep, but don't bring it in around here at tax time."[8]

Customer DL. Another note dated May 22, 1994 from McNabb to DL in the amount of $86,000 was included with a deed of trust with McNabb (for RKM) as the trustee. There was also a revised note and deed of trust for $105,000 in favor of DL dated that same day.

Customers VH and DH. The documents relating to VH and DH included (1) a November 20, 1995 bill of sale that was signed by McNabb, DH and VH for the purchase by VH and DH of a $58,000 equipment pool from Scavenger Leasing; (2) a November 20, 1995 equipment lease between Scavenger Leasing Company and VH and DH, which was signed by McNabb, VH and DH; and (3) a schedule for $58,000 of equipment signed by McNabb, VH and DH. Pursuant to these documents, Scavenger Leasing Company purported to sell certain equipment to VH and DH and then lease the equipment back from them. The lease provided that VH and DH would receive 136 monthly payments of $696. A November 9, 1995 letter from McNabb to VH and DH noted that their purchase of the equipment would be funded by the sale of their existing position in the Keystone K-1 fund.

Customer RS. RS also leased equipment to RKM. Erkel faxed Yee: (1) a letter from McNabb to RS dated November 9, 1995; (2) an unsigned November 15, 1995 bill of sale for $65,000 of computer equipment from RKM to RS; (3) an unsigned November 15, 1995 lease agreement between RS and RKM; and (4) an Addendum to the lease agreement signed by McNabb and RS. The equipment lease agreement provided that RS would receive 60 monthly payments of $650, for a total of $21,000, followed by the return of her $65,000.

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[7] The executed promissory note indicates that PD and FD loaned McNabb $52,500.

[8] PD and FD entered into another promissory note with McNabb through Scavenger on March 8, 1995 in the amount of $85,000.

<u>Customer MR.</u> Finally, Erkel provided an unsigned December 15, 1995 bill of sale for $55,000 of computer equipment from Scavenger Leasing Company to JR and MR, co-trustees of the R Family Trust and an unsigned December 15, 1995 equipment lease agreement between JR and MR as co-trustees for the R Family Trust and Scavenger Leasing Company. The agreement provided for 60 monthly payments of $550 to JR and MR, followed by the return of their $55,000 at the end of the lease period.[9]

After receiving these documents, Yee contacted McNabb and asked him for all documents relating to Scavenger. McNabb denied Scavenger's existence. After Yee told McNabb that he had documentary evidence of the Scavenger account, McNabb admitted that he had set up an account in the name of Scavenger for deed of trust transactions. According to Yee, McNabb then stated that LM was the only customer who had invested in Scavenger, but the transactions never occurred, and he had returned LM's funds to her.[10] Yee told McNabb that he was suspended from conducting any securities business from AIC and that Yee and Bauer expected to see all books and records for Scavenger when they arrived at RKM for the inspection the next day. Yee sent McNabb a written suspension notice that same day.

<u>The December 7 Inspection of RKM.</u> Prior to the December 7 inspection, Erkel phoned AIC and stated that McNabb had stayed at RKM late the night before and had removed documents relating to Scavenger from his files.

On December 7, the day of the audit, McNabb gave Yee a series of documents relating to the promissory notes and equipment leases that comprised the Scavenger

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[9] At the DBCC hearing, McNabb argued that this transaction could not constitute selling away from AIC because the equipment lease post-dated McNabb's December 7, 1995 termination. The securities sales that produced the funds to make this purchase were executed on December 4. The DBCC did not credit McNabb's testimony, nor do we, that at the time of the sales, JR and MR intended to use the funds to purchase a Winnebago. We find, however, that because the equipment lease post-dated McNabb's termination, it is not properly before us for consideration.

[10] On appeal, McNabb asserted that the Scavenger venture began in 1994 when he, LVF and PD decided to invest in two deeds of trust secured by a medical building in Salinas, California. McNabb represented the buyer in that transaction, and as the broker, McNabb would have earned more than $200,000 in commissions. LVF and PD allegedly placed $70,000 and $52,000, respectively, with McNabb, who then deposited them in an account under the name "Robin McNabb d/b/a Scavenger." The deal collapsed after the proposed buyer became entangled in litigation. McNabb then asked LVF and PD if they would consider lending him the funds held in the Scavenger account. Both agreed, and McNabb issued them promissory notes.

venture.[11] McNabb acknowledged that he had established a bank account in the name of "Scavenger" and that this account had been used to collect and disburse funds since May 1, 1994. McNabb admitted that the Scavenger account contained money from the following sources:

1. Customer DL -- $105,000 deed of trust secured by RKM's office;
2. Customer LVF -- $100,000 loan to RKM;
3. Customer GF -- $60,000 loan to RKM;
4. Customer PD -- $137,500 loan to RKM;
5. Customer HS -- $75,000 loan to RKM; and
6. Customer LM -- $209,500 loan to RKM.

All of these loans provided for the payment of interest until maturity, with repayment of the principal as a balloon payment. McNabb also acknowledged the following three equipment leases:

1. Customer VH -- $58,000 of equipment in exchange for $696 per month for 136 months;
2. Customer RS -- $65,000 of equipment in exchange for $650 per month for 60 months; and
3. Customer JR -- $55,000 of equipment in exchange for $550 per month for 60 months.

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[11] McNabb produced the following additional documents: a fictitious business name statement for Scavenger, which was filed on October 5, 1994; a note dated May 30, 1995, from McNabb in the amount of $209,000 in favor of LM, due on June 27, 2005, with an interest rate of 11 percent, and an amortization schedule for the note; a note dated April 12, 1995, from McNabb in the amount of $35,000 in favor of HS and MS, due on May 12, 1999, with an interest rate of 12 percent; a note dated March 9, 1995, from McNabb in the amount of $40,000 in favor of PD and FD, due on August 15, 1996, with an interest rate of 14 percent; a note dated October 13, 1995, from McNabb in the amount of $60,000 in favor of GF and GF, due on November 14, 2000, with an interest rate of 14 percent; a note dated September 14, 1994, from McNabb in the amount of $52,500 in favor of PD and FD, due on May 14, 1994 [sic], with an interest rate of 13.34 percent; a note dated February 16, 1994, from McNabb in the amount of $20,000 in favor of LVF and SVF due on March 14, 1998, with an interest rate of 13 percent; a note dated December 13, 1994, from McNabb in the amount of $50,000 in favor of Customers LVF and SVF, due on January 13, 1998, with an interest rate of 13 percent; and a note dated August 14, 1994, from McNabb in the amount of $30,000 in favor of LVF and SVF, due on August 14, 1998, with an interest rate of 16.80 percent.

McNabb also gave Yee the Scavenger bank statements and reports. McNabb insisted that he had not violated any NASD rules. He stated that each transaction had been entered into individually and that they therefore did not constitute securities transactions.

After Yee had completed his inspection at RKM and returned to the Home Office, Erkel sent him the following: copies of RKM's 1995 cash receipts; RKM's disbursements blotter; and unsigned letters and emails written by McNabb. After receiving the cash receipts and disbursements blotter, Yee terminated McNabb from AIC.

Among these additional documents was an unsigned letter from McNabb to DL, dated January 13, 1995. This letter stated that "since this is a confidential transaction, the interest payments are run through the Scavenger checking account along with interest payments to the individuals that you see on the report. Your investment, however, is separate." The letter went on to state that "Scavenger is an account that is washing funds for clients in miscellaneous investments. Now, [D], this information is strictly confidential, okay?"

Another unsigned letter from McNabb to LVF, also dated January 13, 1995 explained the 1994 report and Scavenger budget for 1995. The letter stated the following:

> Please note the Deed of Trust investment of $105,000, and the interest payments to "DL." This is a private investor and not part of the Scavenger investment network. However, the investor is carried through Scavenger to facilitate accounting of income and expense.
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> Scavenger 1994 investments total $192,500. Each person in Scavenger is receiving interest payments monthly. A recap of each investor's position is provided with a complete breakdown of payments and payment date per investor.

In a November 9, 1995 letter to equipment lease-holders VH and DH, McNabb wrote as follows:

> Frankly, you made a good move with the leasing program. You would not be able to sustain a high income stream of payments from the Keystone [K-1 fund] like you will receive from the leasing program. Also, you will receive a much higher income for a longer time period with a return of your original investment capital at the end of the leasing investment.

In an undated statement on RKM letterhead, which statement was signed by McNabb and LVF, PD and FD, McNabb described Scavenger as a program:

> to bring together investors of strong earning and net worth potential with highly controlled non-traditional investments – for high returns. The specific goal of this program is to generate fees, points, returns of principal and interest income from targeting projects requiring money for interim purposes of the borrower.
>
> The projects will vary in length and all have one common characteristic – they are all created, implemented and monitored by Rob McNabb, CFP, ChFC, CLU, EA, the Chief Executive Officer of RKM Financial Group: A Personal Financial Planning Company.
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> All monies invested by the investor will first go into the RKM Properties Brokers Trust Account to await rapid disbursement. . . . The investor will receive a stated interest payment monthly from the RKM Financial Group through a Union Bank account titled "SCAVENGER."

Throughout the period leading up to the December 7 audit, McNabb routinely denied the existence of Scavenger in various emails he sent to his RKM employees. On December 8, 1995, the day after he was terminated by AIC, McNabb sent the following email to Erkel:

> I just did not want you involved in the audit. I was really saying to you, this is my matter and I don't want you drawn into it. After reading the NASD manual the night before the audit, I decided that full disclosure was the correct course. The issue was whether the loans were a security. They are not. So, I disclosed.

Throughout the NASD Regulation investigation, McNabb provided Kirk with other documentary evidence, including bank statements, canceled checks from the Scavenger bank account, and copies of customers' notes. These notes contained largely the same terms and were made out to the same customers as those notes that had been previously provided to Yee, but they were different in the following respects: these notes were issued by "Rob McNabb" unlike the previously provided notes, which were issued by "Robin B. McNabb"; these notes had an additional clause raising the interest rate after the due date; the due date on the $85,000 note to PD and FD had been corrected to read "May 15, 1996"; and the $35,000 note to HS and MS had been changed to reflect an interest rate of 14 percent.[12]

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[12] At the DBCC hearing, McNabb testified that all of the notes had recently been "reconstituted" to reflect that all payments that customers had received so far were repayments of the principal, and not interest payments. Pursuant to the terms of the "reconstituted" notes, all of the interest was to be paid at the end of the term. Therefore,

The DBCC and NAC Proceedings

Throughout both the investigation and the DBCC hearing, McNabb insisted that Scavenger did not exist as an entity, but rather was simply the name of a bank account that he had opened to keep his personal business transactions separate from his professional transactions. He claimed that he and LVF came up with the name "Scavenger" as a joke because by entering into these transactions with the customers (collectively, the "Customers"), McNabb was "scavenging" for money.

McNabb claimed that he created the Scavenger bank account because he did not want his business partner, Karol Bell ("Bell"), whom he divorced in 1990, to find out about the transactions. He testified that he owed Bell $125,000, and he was concerned that she would claim a part of the money that he was borrowing from the Customers. McNabb claimed that he therefore denied Scavenger's existence to her as well as to other RKM employees, whom he feared might tell Bell. He also stated that the Customers did not like Weeks. He claimed that he denied Scavenger's existence to Weeks because he wanted to prevent Weeks from dealing with the Customers.

He claimed that the various documents that referred to Scavenger were never effective, and that they thus did not evidence transactions between the Customers and an entity called Scavenger. He maintained that the transactions he engaged in with the Customers were not securities transactions, but were personal loans from his customers to him and equipment leases between RKM and the customers. He admitted that he used the proceeds from all of the transactions to pay his office expenses.

In support of his argument at the DBCC hearing, McNabb introduced declarations from the Customers. In these declarations, the Customers attested to their trust and confidence in McNabb. The Customers stated that they intended to make personal loans to McNabb, and that they knew that McNabb planned to use the proceeds for his own business and personal financial purposes. Each Customer stated that McNabb had explained the risks involved in the investments and that the investments were not collateralized. In some of these declarations, however, the Customers stated that they were looking forward to receiving the type of return they would receive under these arrangements.

The DBCC noted in its decision that the Customers would not cooperate with NASD Regulation during the investigation and that the District was therefore left with only limited documentary evidence of the Customers' knowledge and intentions. According to the DBCC decision, NASD Regulation told McNabb that if he wanted the

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the customers allegedly have not owed taxes on the principal payments that they have received to date.

Customers' declarations to be given weight, he should call the Customers as witnesses at the DBCC hearing. McNabb declined to do so. The DBCC speculated that the Customers' refusal to cooperate with NASD Regulation was an attempt to protect McNabb and was motivated by their loyalty to McNabb, who was providing the Customers with an allegedly tax-free investment by deferring the payment of interest until the payment of principal was completed.

At the hearing before a subcommittee of the National Adjudicatory Council (the "NAC") on November 23, 1998 (the "NAC Hearing"), however, David Watson, the regional attorney for the District, admitted that no one from the District had even made an attempt to contact the Customers. He stated that staff had merely assumed, based on Yee's description of events, that the Customers would not cooperate with the NASD.

Discussion

We must first determine whether the promissory notes and equipment leases at issue are "securities" pursuant to Section 3(a)(10) of the Securities Exchange Act of 1934 (the "Exchange Act"). If neither the notes nor the leases are "securities," then neither Conduct Rule 3040, which prohibits registered representatives from participating in private securities transactions without informing the firm, nor Conduct Rule 2310, which prohibits registered representatives from making unsuitable recommendations to customers, will apply to the transactions McNabb entered into with the Customers. On the other hand, if these instruments are "securities," then further analysis is needed to determine whether or not violations of Rule 3040 and Rule 2310 have occurred.

We have reviewed the record, the arguments, and the well established case law, and with respect to all but one set of customers, we affirm the DBCC's finding that McNabb violated Conduct Rules 2110, 3040 and 2310 by engaging in private securities transactions without informing his employer and by recommending the sale of these securities to some customers without reasonable grounds to believe that the securities were suitable for those customers.

Are the Promissory Notes "Securities"?

Under Section 3(a)(10) of the Exchange Act, a security is defined as any one of a long list of financial instruments, beginning with "any note." Courts, however, have not interpreted Section 3(a)(10) to cover literally "any note." In Reves v. Ernst & Young, 494 U.S. 56 (1990), the Supreme Court of the United States held that the intent of Congress in drafting the SEA "was to regulate investments, in whatever form they are made and by whatever name they are called." Id. at 61. Thus, Congress did not necessarily mean "any note," but rather only those notes that it deemed to be investments in need of regulation.

The Supreme Court in Reves developed the "family resemblance" test for determining whether a particular note is in need of regulation and should therefore be deemed a "security" for purposes of federal securities laws and regulations. Under this test, every note is presumed to be a security, unless it bears a strong resemblance to one of several types of expressly enumerated financial instruments.[13] If an instrument is not sufficiently similar to one of the statutorily enumerated securities, we must then use the same four factors to determine whether the instrument is of a type that should be added to the list. The following four factors must be considered: (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (2) the instrument's plan of distribution to determine whether it is an instrument in which there is common trading for speculation or investment; (3) whether the investing public would reasonably expect the instrument to be considered a security; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering the application of the Securities Acts unnecessary.

Factor One: Motivation of the Parties. The Supreme Court in Reves explained that "[i]f the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'" 494 U.S. at 66. If, on the other hand, "the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, . . .[then] the note is less sensibly described as a 'security.'" Id.

In his brief, McNabb claimed that he borrowed the money "to raise funds for his business because of the short fall in cash flow and the need to resolve the financial aspects of the dissolution of his marriage to his business partner." After examining the way in which he used the funds, we find that he raised the money "for the general use of a business enterprise." See In re William Louis Morgan, Exchange Act Rel. No. 32744 (Aug. 12, 1993) (where representative raised money to overcome reduced cash flow at the branch office by selling notes under name of non-existent corporation, SEC found notes were not sold for purely commercial or consumer purpose but rather for use of a business enterprise).

We must also examine the record evidence to determine the Customers' motivations and expectations in buying the notes. In this case, there is conflicting evidence of the Customers' motivations. On the one hand, there is evidence that the notes

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[13] The types of notes that are excluded from the definition of "security" are the following: a note delivered in consumer financing, a note secured by a mortgage on a home, a short-term note secured by a lien on a small business or some of its assets, a note evidencing a 'character' loan to a bank customer, a short-term note secured by an assignment of accounts receivable, a note that simply formalizes an open-account debt incurred in the ordinary course of business, or a note evidencing a loan by a commercial bank for current operations. Reves v. Ernst & Young, 494 U.S. at 65.

offered monthly payments and very favorable interest rates, ranging from 11 percent to 17 percent.[14] PD stated that he and his wife "enjoyed receiving the monthly payments rather than having all our funds wrapped up in equities." Similarly, LM attested that she preferred purchasing the notes to buying equities, where she might "really lose [her] money." Many of the noteholders apparently liquidated other investments that they held through RKM to fund the purchase of the notes. Thus, the Customers appear to have used money that they had earmarked as investment money to purchase the notes. Furthermore, the notes were listed as part of the Customers' investment portfolios. Finally, many of McNabb's letters to the Customers referred to the Scavenger notes as "investments," and the undated, signed statements declaring Scavenger's purpose shed light on the parties' motivations and expectations. The goal was

> to bring together investors of strong earning and net worth potential with highly controlled non-traditional investments – for high returns. The specific goal of this program is to generate fees, points, returns of principal and interest income from targeting projects requiring money for interim purposes of the borrower.

On the other hand, both McNabb and the Customers, through their declarations, insisted that they neither intended nor considered the notes to be "investments" or "securities." The Customers stated in their declarations that their motivation in lending the money was to help out their friend, Rob McNabb. The Customers also insisted in their declarations that they were aware of the risks associated with these purchasers and that they would not suffer financial harm if McNabb defaulted on the notes.

We conclude that the evidence weighs in favor of finding that the customers were primarily interested in the profit that the notes would generate. We note that the Commission's recent decision in In re John P. Goldsworthy, Exchange Act Rel. No. 40000 (May 18, 1998) made clear that the record must contain sufficient probative evidence of the noteholders' motivations to enable a thorough evaluation of the noteholders' expectations and intentions. We find that in this case, unlike in Goldsworthy, the DBCC did in fact have documentary evidence of the customers' intentions in the form of account statements, customer records and declarations submitted on behalf of McNabb.[15]

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[14] The fact that the Customers received a fixed rate of return does not undermine the presumption that these notes are securities. Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808, 813 (2d Cir. 1994).

[15] The SEC remanded the Goldsworthy case because the NASD had failed to collect evidence "concerning the circumstances surrounding the sale of the notes from which the reasonable motivations and expectations of the noteholders, as well as the plan of distribution, may be discerned." In that case, the NASD examiners did not interview the customers. Furthermore, the SEC noted that it appeared from the record that the NASD had access to "customer questionnaires compiled by the State of Louisiana Securities

Although we note that all of the customers stated that they entered into the transactions in order to help McNabb through a difficult financial period, all of them received extremely generous interest rates. Indeed, at least two of the Customers who submitted declarations acknowledged that these anticipated returns factored into their decisions to purchase the notes. Courts have noted that favorable interest rates indicate that a profit was the primary goal of the lender. Reves, 494 U.S. at 67-68; Stoiber v. SEC, No. 98-1062, 1998 U.S. App. LEXIS 30830, at *14 (D.C. Cir., Dec. 8, 1998).

Factor Two: Plan of Distribution. The District must also determine whether these notes are instruments in which there is "common trading." "Common trading" is established "if the instrument is 'offered and sold to a broad segment of the public. . . .'" Stoiber v. SEC, 1998 U.S. App. LEXIS 30830, at *16 (quoting Reves, 494 U.S. at 68).

In Stoiber, the D.C. Circuit Court of Appeals considered several factors in analyzing this prong of the Reves test. The court found that the following facts weighed against finding "common trading": Stoiber sold the notes to 13 customers with whom he had personal relationships; and although the notes did not preclude trading in a secondary market, which made "common trading" theoretically possible, none of the customers actually resold their notes.[16] The court also noted, however, that Stoiber did not solicit sophisticated investors.[17] Instead, he solicited individual investors to whom he gave little information concerning the transactions. The court found that this group constituted a subset of the general public, albeit a small one, and it found that the weight of the evidence

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Department" . . . "and to documentation of customer complaints, [and yet] no noteholder complaint letters, questionnaires, account statements, or other relevant customer records were introduced."

[16] Other courts have also examined the number of customers to whom the notes were sold. See In re Prime Investors, Inc., Exchange Act Rel. No. 38487 (Apr. 8, 1997) (court easily found a pattern of common trading where there were "three successive newspaper advertisements [for the notes] and the ready availability to Prime's walk-in customers of literature [for] the program"). Courts also have considered whether the notes allowed secondary trading. See, e.g., Banco Espanol de Credito v. Security Pacific National Bank, 973 F.2d 51, 55 (2d Cir. 1992) (court found no plan of distribution where notes expressly prohibited resale without permission of issuer).

[17] Other courts have found that a small number of sophisticated investors can preclude a finding of "common trading." See Resolution Trust Corp. v. Stone, 998 F.2d 1534, 1539 (10th Cir. 1993) (where the notes were sold to "a very specialized and sophisticated secondary market that consisted of certain financial institutions and insurance companies," they were not "offered and sold to a broad segment of the public," as is required to find "common trading").

fell in favor of finding "common trading." See In re William Louis Morgan, supra ("common trading" found where notes were sold to members of the general public).

As in Stoiber, the notes in this case did not on their face preclude trading in a secondary market, although there was no indication that any of the noteholders even considered selling their notes to a third party. Similarly, as in Stoiber, the number of noteholders in this case is relatively small. McNabb, like Stoiber, solicited, and sold the notes to, individuals with whom he had personal relationships, and not to sophisticated investors. Unlike Stoiber, however, McNabb apparently informed his Customers of the risks associated with these investments. Nonetheless, the fact that McNabb sold the notes to members of the general public satisfies this prong of the test. We therefore find the requisite plan of distribution for these notes.

Factor Three: Public Expectations. The Supreme Court in Reves made clear that it would consider financial instruments to be "securities" based on public expectations, even where an economic analysis of the transaction might suggest otherwise. 494 U.S. at 66. The D.C. Circuit explained that "[w]hether notes are reasonably perceived as securities generally turns on whether they are reasonably viewed by purchasers as investments. [citations omitted] When a note seller calls a note an investment, in the absence of contrary indications 'it would be reasonable for a prospective purchaser to take the [offeror] at its word.'" Stoiber v. SEC, 1998 U.S. App. LEXIS 30830, at *18 (quoting Reves, 494 U.S. at 69). Conversely, when note purchasers are expressly put on notice that a note is not an investment, it is reasonable to conclude that the public would not expect the notes to be securities. Banco Espanol de Credito, 973 F.2d at 55-56.

In his letters to the Customers, McNabb frequently referred to the notes as "investments," and in at least one instance, he even stated that the rate of return the Customers would obtain from their note was greater than they could have obtained from investing in stocks or bonds. Although we recognize that the Customers' affidavits stated that they did not consider the notes to be investments, this factor is based on objective evidence and not the subjective beliefs of the parties. We therefore find that the public would have been reasonable in perceiving these notes to be "securities."

Factor Four: Another Regulatory Scheme That Significantly Reduces Risk. We do not find any risk-reducing factors to suggest that these promissory notes were not "securities." The notes were uncollateralized and uninsured, and we do not find that the demand feature of the notes eliminated the risk usually associated with "securities." As the Court in Reves explained, "a demand only eliminates risk when, and if, payment is made . . . ." 494 U.S. at 69.

The Equipment Leases Are "Securities"

We also find that there is ample evidence to support the DBCC's conclusion that the equipment leases were "securities." "Investment contracts" are among the other instruments deemed "securities" under section 3(a)(10) of the SEA. Our analysis of the equipment leases as "securities" therefore begins with Securities and Exchange Commission v. W.J. Howey & Co., 328 U.S. 293 (1946), which defined "investment contracts."

In Howey, the Supreme Court defined an "investment contract" as "a contract, transaction or scheme whereby [1] a person invests his money [2] in a common enterprise and [3] is led to expect profits solely from the efforts of the promoter or third party." Id. at 299. Both the courts and the Commission have held that equipment leases like those at issue in this case are "investment contracts" under the Howey test and are therefore "securities" for purposes of the federal securities laws. See Albanese v. Florida National Bank of Orlando, 823 F.2d 408 (11th Cir. 1987); see also In re Ronald W. Gibbs, Exchange Act Rel. No. 35998 (July 20, 1995).

McNabb argued on appeal that the equipment leases could not be "securities" because they failed the third prong of the Howey test. Specifically, McNabb asserted that there was no evidence that the monthly lease payments were dependent on the profitability of his business and there was no evidence that he would be unable to make the lease payments if his business lost money. Therefore, McNabb argued, the Customers did not "expect profits solely from the efforts" of McNabb.

Our analysis of the record and the case law, however, shows that these equipment leases do pass the Howey test. These equipment leases provided for the lease back by McNabb of equipment that Scavenger Leasing or RKM sold to the Customers. Under the terms of the leases, the Customers had no control over the equipment after they leased it back to RKM. The leases provided for substantial monthly interest payments followed by the return of the entire principal amount at the end of the lease period. There is no question that the equipment leases involved the investment of money, and as the case law makes clear, the equipment leases satisfied the other two prongs of the Howey test as well.

In Albanese v. Florida National Bank of Orlando, supra, the investors purchased certain equipment from a company called PCI. The investors then leased the equipment back to PCI for a period of months during which the investors collected monthly payments. The court found that the first two prongs of the Howey test were satisfied. In finding that the third prong was also satisfied, the court noted that during the lease period, the investors had "no significant degree of control" over the equipment. Thus, the court concluded that the investors were dependent on the lessee's efforts for their promised monthly payments.

Similarly, in In re Ronald W. Gibbs, supra, the SEC examined contracts the investors entered into with a company called RAA for the purchase and lease-back of certain restaurant equipment. Under the terms of those equipment leases, the investors collected monthly payments, part of which represented the principal and part of which represented the interest on the investment. RAA assured the investors that they would be paid back regardless of the success of the particular enterprise for which the equipment was leased. Like the court in Albanese, the SEC found that the first two prongs of the Howey test were satisfied. The SEC noted that the "common enterprise" requirement is satisfied where there is "horizontal commonality, that is, investors' funds are pooled and their fortunes are interrelated." In re Ronald W. Gibbs, supra. The SEC also found that where the "investors were to do nothing but collect profits from their investment," the third prong of the Howey test was satisfied.

Under the terms of the leases, RKM and Scavenger through McNabb had complete control over and unencumbered use of the equipment. None of the investors was to take delivery of the equipment, and none did so. Furthermore, the Customers had no involvement in the business for which the equipment was leased, and they merely collected their monthly lease payments.

The leases at issue in this case were identical in all relevant respects to the equipment leases that were held to be "investment contracts" in Albanese and Gibbs. As in those cases, the Customers in this case did not retain the ability to control the profitability of their investment, and they were to do nothing but collect the profits from their investments. Therefore, these equipment leases meet all three prongs of the Howey test and are "securities."

## McNabb Violated Rule 3040

Rule 3040 requires associated persons to provide their employers with written notice of private securities transactions, which are defined to be securities transactions outside the regular course of an associated person's employment with a member. This notice must be furnished before the transaction takes place. There is no dispute in this case that McNabb did not inform AIC before he entered into these transactions with the Customers. In fact, McNabb went to great lengths to hide these transactions from both his employer and from his employees at RKM. AIC only discovered the transactions after employees of AIC became suspicious and conducted their own investigation.

Because we find that the promissory notes and equipment leases were "securities" under the Exchange Act, we conclude that McNabb violated Conduct Rule 3040 when he engaged in these transactions without informing AIC.

## Some of McNabb's Recommendations Were Unsuitable

Conduct Rule 2310 provides that in recommending to a customer the purchase of a security, a representative must have "reasonable grounds for believing that the recommendation is suitable for such customer" based on the customer's other security holdings and financial situation and needs.

Customer DL. DL's new account form indicated that, at the time of his investment, he had an annual income of $50,000 and a net worth of $100,000, exclusive of home and automobiles. McNabb sold DL a $110,250 note, which represented twice DL's annual income and more than his liquid net worth. Based on these facts of DL's financial condition and other securities holdings, which were disclosed to McNabb, we find that McNabb's recommendation was unsuitable given the illiquid nature of the note and the potential risk involved in this investment.

Customers HS and RS. The new account form for HS and RS, which was dated eight months prior to their investment, indicated that they were 72 and 68 years of age, respectively. The form indicated that HS was an engineer with an annual income of between $75,000 and $100,000. The form reflected that they had liquid assets of $85,000 and a net worth of $204,000, exclusive of home and automobiles. McNabb recommended that they purchase notes totaling $75,000. After they purchased these notes, HS and RS completed an investor questionnaire for the SEC. They indicated on this questionnaire that their annual income was in excess of $100,000, that their net worth exclusive of home was $150,000 to $250,000, and that their liquid net worth was $50,000. We find that the recommendation to purchase $75,000 worth of notes was unsuitable under either set of facts.

Customer LM. LM's new account form indicates that she was a 75 year old architect with an annual income of $33,000, a net worth of $355,000 and a liquid net worth of $225,000. On her SEC questionnaire, LM indicated that her income was between $25,000 and $50,000, that her net worth exclusive of home was $250,000 to $500,000 and that she had a liquid net worth of less than $50,000. Given either set of figures, we find that McNabb's recommendation that LM purchase a note for $209,500 was unsuitable.[18]

Sanctions

The DBCC ordered that McNabb be censured, fined $100,000 ($50,000 for each cause) and barred from association with any member of the NASD in any capacity. We modify these sanctions as explained below.

We note that the 1996 edition of the NASD Sanction Guideline ("Guideline") for selling away violations recommends a fine in the range of $5,000 to $50,000 and a suspension or bar, in more serious cases. The Guideline for suitability recommends a fine in the range of $5,000 to $50,000. The Guideline also recommends requiring

[18] Because we find that the transaction with JR and MR was not entered into until after McNabb's termination from AIC, we reverse the DBCC's finding that McNabb's recommendation that they enter into this transaction was unsuitable.

requalification by examination and in cases involving numerous recommendations of clearly unsuitable securities, a suspension in all capacities for 10 to 30 business days.[19]

An employee's duty to inform his or her firm of private securities transactions serves a very important regulatory purpose. It protects the firm from exposure to both loss and litigation from dissatisfied customers, and it protects customers from the dangers of unsupervised investment activity. We agree with the DBCC that as a registered principal and the manager of an office of supervisory jurisdiction of AIC, McNabb should have been familiar with his responsibilities to AIC and with NASD Conduct Rules. We are also troubled by the fact that McNabb went to great lengths to conceal these transactions from everyone, including AIC. McNabb's conduct places this case squarely in the class of "serious cases" that warrant a bar or a suspension. We note that McNabb has met all of his obligations to the note- and lease-holders and that none of them, fortunately, lost money. In these respects, this case differs from other selling away cases where registered persons withheld information concerning the risks of the investments from the customers and where customers suffered egregious financial harm. See e.g., In re William Louis Morgan, supra. We therefore modify the sanctions as follows: we order that McNabb be censured, fined $50,000 and barred from association with any member of the NASD in any capacity.

Accordingly, McNabb is censured, fined $50,000 ($25,000 for each violation), barred from association with any member of the NASD in any capacity, and assessed costs in the amount of $1,294.90.[20] The bar is effective upon service of this decision.

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Senior Vice President
and Corporate Secretary

[19] See Guideline (1996 ed.) at 45 (Selling Away) and 52 (Suitability).

[20] 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 Procedural 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 sanction, after seven days' notice in writing, will summarily be revoked for non-payment.