

BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of

District Business Conduct Committee
for District No. 5,

Complainant,

vs.

Respondent 1,

Respondent.

DECISION

Complaint No. C05960041

District No. 5

Dated: October 10, 1997

Respondent 1 has appealed, pursuant to NASD Procedural Rule 9310, an October 24, 1996 decision of the District Business Conduct Committee for District No. 5 ("DBCC"). We find that Respondent 1 did not violate NASD Conduct Rule 2110 by making negligent misrepresentations to the public and that he did not violate Membership and Registration Rule 1031(a) (formerly Part III, Section 1(a) of Schedule C to the By-Laws) by failing properly to register with the Association, as alleged in the complaint. We therefore reverse the DBCC's findings of violations and eliminate all sanctions that the DBCC imposed against Respondent 1.

Factual Background

Respondent 1 entered the securities industry in 1984, when he became associated with a firm as a registered representative. Although Respondent 1 was later employed by Firm A, Firm B, and Firm C, none of those firms required Respondent 1 to register in any capacity with the Association. From April 1992 through November 1994, Respondent 1 was associated with a member firm, Firm D (or "the Firm"), and was not registered with the Association in any capacity. Respondent 1 currently is employed by an investment management company, and is not registered with the Association in any capacity.

Firm D hired Respondent 1 on April 16, 1992 as a research analyst. Firm D's Senior Vice-President and Director of Research, supervised Respondent 1. The Director of Research, in consultation with Firm's compliance department, decided that Respondent 1 did not need to register with the Association in any capacity. Firm D paid Respondent 1 a yearly salary, plus a bonus based upon subjective factors unrelated to sales of stock in the securities he analyzed and on which he reported. Respondent 1 did not receive sales commissions from Firm D.¹

¹ The DBCC's decision hinted that Respondent 1 had a conflict of interest because he owned [Company 1]

The Director of Research assigned Respondent 1 to analyze the stock of Company 1. Company 1 was a large restaurant franchisee, controlling approximately 200 Company 2 and 70 Company 3 franchises. Respondent 1 became familiar with Company 1 during his employment at Firm C when, in the Fall of 1991, he attended a meeting at which Company 1's President, made a presentation about the company. Respondent 1 later drafted and proposed to Company 1's President a financing package that would have enabled Firm C to become Company 1's investment banker. Ultimately, Firm E and Firm D co-managed Company 1's financing and became Company 1's investment bankers. At the time Firm D hired Respondent 1 and assigned him to analyze Company 1, Firm D's management was aware of Respondent 1's familiarity with Company 1.

The alleged violation in this case stems from Respondent 1's analysis of and statements about two significant events involving Company 1 in 1993: (1) a potential merger between Company 1 and Company 2 (the "Merger"); and (2) a lawsuit between Company 1 and Company 4. The DBCC's complaint, issued on May 3, 1996, alleged that from May 1993 through December 1993, Respondent 1, in connection with the sale of stock of Company 1, misrepresented to customers of Firm D the details of the Merger and the settlement value of the Lawsuit to Company 1 stockholders.

Respondent 1's Analysis Of The Merger

In late June of 1993, shortly after releasing his first research report regarding Company 1, Respondent 1 went to Company 1's annual meeting, expecting the company to announce a stock buy-back plan. Respondent 1 claimed that there were three bases for this expectation. First, in mid-June Company 1 announced the signing of a bank credit agreement that would enable the company to make dividend payments and also to make open-market stock re-purchases. Second, Company 1 had completed a similar stock buy-back between 1988 and 1991. Third, in February and March of 1993 Company 5 had invested approximately \$50 million in Company 1, including purchasing 1.5 million shares at \$10 each. Because the widely-respected Company 5 had recently paid \$10 per share for Company 1 stock, and the stock was trading for \$8 at the time of the annual meeting, Respondent 1 reasoned that Company 1 would view the stock as a bargain at that price.

When Company 1 failed to announce a stock repurchase plan, Respondent 1 arranged a lunch meeting with Company 1's President and two other principals of Company 1 to inquire further. According to Respondent 1, Company 1's President stated that implementing a stock re-purchase "would f--- up a pooling." Respondent 1 testified that Company 1's President's statement about a pooling indicated to him that Company 1 was considering a pooling of interests or merger with another entity. Respondent 1 explained that he believed

stock during his employment at Firm D. Respondent 1 first purchased Company 1 stock on July 15, 1992, while he was at Firm D, and before he published any recommendations. As of the DBCC proceedings, Respondent 1 still owned the Company 1 stock and had incurred an unrealized loss of approximately \$40,000. Respondent 1 was not charged with a conflict of interest, nor is there any evidence that such a conflict existed. Respondent 1's ownership of the stock, in and of itself, is not a violation of the securities laws or NASD rules. There is no evidence that Respondent 1 traded ahead of his research reports, violated any applicable Firm D's policy, or received anything of value from anyone at Company 1.

that Company 1 could not engage in a buy-back within a year of a pooling. Based upon this assumption, he believed that the Merger was going to happen within a year, but did not form an opinion about what entity would be the merger partner.

In July 1993, Respondent 1 began to suspect that Company 1 might merge with Company 2. In June of 1993, Company 2's former Chairman, held a press conference to announce that Company 2 had unilaterally canceled an agreement to purchase over four million shares of Company 2 stock (11 percent of all outstanding shares) from him for 22 7/8 per share. In July of 1993, Bloomberg News reported that Company 5 had approached Company 2's former Chairman to purchase his stock, and when Company 2's former Chairman refused to sell, began purchasing Company 2 shares on the open market. Knowing that Company 5 had recently purchased a large block of Company 1 stock and that Company 1 was the largest Company 2 franchisee, Respondent 1 inferred that Company 5 intended to purchase a large stake in Company 2 and then pressure Company 2's management to merge with Company 1. Respondent 1 had observed Company 5 implement this strategy before, in what he perceived to be similar situations, most notably, a situation involving a chain of hotels. According to Respondent 1, at this point, he began to believe that the "pooling" that Company 1's President had mentioned earlier had to involve Company 2 pooling with Company 1. Respondent 1 never contacted Company 2 or Company 5 to discuss his theory about the Merger.

The Merger was not announced for another two years. When news reports discussing a possible Company 1/Company 2 Merger were published in September 1994, Company 2 denied the existence of Merger discussions. The Merger was formally announced in 1995 and was consummated in 1996. According to Respondent 1, a Form S-4 filed in 1996 with the SEC revealed that the parties had had merger discussions in August 1993.

Respondent 1 Analysis Of The Lawsuit

The second Company 1-related event that Respondent 1 analyzed was the filing of a lawsuit by Company 1's wholly-owned subsidiary, Company 6 against Company 7 and Company 4 on November 1, 1993. According to Respondent 1, Company 6 and Company 7 each owned various cellular licenses, had cooperated with each other to develop the value of their respective licenses, and had discussed jointly selling their licenses as a network to increase their value. Company 6 and Company 7 eventually entered separate sales contracts with Company 4 that, from Company 6's perspective, guaranteed that Company 4 would offer Company 6 and Company 7 similar purchase terms for the licenses. When Company 4 later resold the licenses for approximately \$1 billion, Company 7 sued Company 4 for \$250 million, alleging that Company 4 and Company 7 had agreed that Company 4 would pay Company 7 25 percent of Company 4's proceeds if Company 4 resold the licenses. Company 6 and Company 1 also sued, alleging that they were entitled to equal payment from Company 4 and to additional damages from Company 4 and Company 7 for failing to disclose their side-agreement.

In November of 1993, Respondent 1 drafted three versions of a research report about the Lawsuit. The first draft stated that "based on the facts of the case, we estimate the value of the ultimate payment will be at least \$500 million (half from Company 4/half from Company 7) before any punitive damages, legal fees, interest,

etc." Firm D's compliance department did not approve this language. Another draft reported that "[A]lthough we cannot speculate on the outcome of the lawsuit, this damage request represents as much as \$100 [per share] (66% of \$1.55 billion, trebled, divided by 30 million fully diluted shares)." Again, Firm D's compliance department refused to approve issuance of this report. Each draft of the report hypothesized that Company 4 would want to settle the lawsuit quickly because the company was being offered for sale to Company 8. The drafts also noted the difficulty of predicting the outcome and timing of a lawsuit. According to Respondent 1, when Firm D's compliance department found the third draft to be too speculative, he became frustrated and stopped drafting the report. The report was never published.²

Respondent 1 Statements To Firm D's Salespeople

In June of 1993, Respondent 1 began discussing the possibility of a Company 1/Company 2 merger. Firm D's equities sales force held regular morning meetings at which members of Firm D's research department, including Respondent 1, regularly spoke. During the relevant period from June through December of 1993, Respondent 1 addressed several morning meetings where he spoke about the Merger and the Lawsuit involving Company 1. The record establishes that the Firm D's employees who attended those meetings believed that Respondent 1 was articulate, well-organized and persuasive in style, and that he gave detailed and informative presentations that inspired confidence in his analysis.

A listed trader at Firm D during 1993, attended morning meetings at which Respondent 1 discussed Company 1. The Firm D trader recalled Respondent 1 saying about the Merger that "it was common sense to him [Respondent 1] that something might happen." According to the Firm D trader, Respondent 1 did not categorically say that the Merger would occur, or discuss a time frame during which it might happen. The Firm D trader also recalled that Respondent 1 discussed the Lawsuit at a morning meeting. The Firm D trader recalled that Respondent 1 mentioned a settlement value for the Lawsuit of as much as \$4 to \$8 per share, but did not recall Respondent 1 discussing the settlement value of the Lawsuit in terms of millions of dollars. The Firm D trader indicated that although Respondent 1 did not guarantee that there was going to be a merger, he "was very forceful about emphasizing that people should buy stock." Tr. at 217, 218.

JW, a registered representative at Firm D for 25 years, recalled that Respondent 1 spoke about the Merger and the Lawsuit at Firm D's morning meetings. JW did not recall Respondent 1 guaranteeing that the Merger would occur, but simply indicating that it would make economic sense. With respect to the Lawsuit, JW recalled Respondent 1 saying that the settlement value of the Lawsuit was \$500 million, and that the share price of Company 1 stock would increase once the Lawsuit settled. According to JW, Respondent 1 gave specific dates for the settlement of the Lawsuit, but that Respondent 1 would change the date as it approached, due to problems arising in the Lawsuit. JW did no independent research on Company 1, but shared with his

² The record shows that Respondent 1 issued only one research report on Company 1 during the relevant period of the complaint -- May to December of 1993. This report issued before Respondent 1 attended Company 1's annual shareholder meeting and before he began hypothesizing about the Merger. Respondent 1 issued at least four other research reports on Company 1 after the relevant period of the complaint, none of which directly addressed the Merger or the Lawsuit.

clients the information that Respondent 1 provided to him about the Merger and the Lawsuit, and also purchased Company 1 stock for his own account.

Respondent 1 submitted affidavits from two other Firm D's employees, HH and BN, both equity salesmen with Firm D during the relevant period, who attended morning meetings at which Respondent 1 discussed Company 1. HH and BN recall that Respondent 1 discussed the Merger and the Lawsuit at these meetings, but that he was very candid about the risks associated with Company 1 stock. HH wrote that "I never heard him say that he knew when Company 1 and Company 2 would merge....I also never heard him say he knew what the price would be at the time a merger was finally done." BN noted that "Although Mr. Respondent 1 believed that Company 1 and Company 2 would likely merge and that the lawsuit could result in a large award or settlement to Company 1, he always stated the risks associated with owning the stock candidly."

A Firm D market maker, did not attend the morning meetings at which Respondent 1 discussed Company 1, but he testified that Respondent 1 was "cheerleading" about the Merger. The Firm D market maker testified that although there were discussions about the Merger, there were no details discussed. He stated that he also had heard that the settlement value of the Lawsuit would be worth approximately \$4 to \$6 per share. He also thought that that Respondent 1 "[came] across as a believer in his stocks" in his presentations at sales meetings.

The Director of Research did not attend the morning meetings, but it was her understanding, as Respondent 1's supervisor, that Respondent 1 thought of a merger involving Company 1 as a hypothetical situation. She indicated that although he discussed a merger with the registered representatives at Firm D, any discussions were in general terms as a possibility, a "what-if scenario."³

Respondent 1's Alleged Misstatements To Firm D's Customers

Three of Firm D's customers – Customer LH, Customer MH, and Customer PH-- testified about having invested in Company 1 stock based, they claim, on information Respondent 1 provided or statements Respondent 1 made. Both Customer LJ and Customer MH's securities accounts at Firm D were handled by MC. JW handled Customer PH's account. As explained below, Customer PH was a sophisticated investor who often dealt directly with Firm D's trading desk.

Customer LJ opened a personal securities account at Firm D in 1989 with MC as his account representative. Customer LJ met MC through Customer LJ's business associates who were long-time friends of MC's. Customer LJ was a short-term trader who, in addition to trading stocks, also traded options and

³ WM and WC were registered representatives at Firm D during the relevant period. Both attended the morning meetings at which Respondent 1 discussed Company 1 stock and both had clients who purchased Company 1 stock, lost money on it, and later filed complaints. Although both WM and WC were potentially important witnesses in the case, neither testified at the hearing. Both submitted affidavits instead. The affidavits are largely identical, drafted in generalities, and lacking in credibility. Accordingly, we place little evidentiary weight on the substance of WM's and WC's affidavits.

commodities and used margin in his Firm D account. Between June 29 and September 1, 1993, Customer LJ purchased 18 thousand shares of Company 1 in five transactions; each successive purchase was at a higher price than the last.

Customer LJ testified that he purchased Company 1 stock on MC's advice. MC told him that Firm D's research department had reason to believe that a merger between Company 1 and Company 2 would occur. MC informed Customer LJ of Company 5's involvement in Company 1 and the implications of their involvement. The stock, then worth approximately \$8 per share, was expected to be worth \$15 or \$16 per share after the Merger according to MC. At various times, MC told Customer LJ that the Merger could happen at any time, within a week or two, that he could not know the time frame for sure, and that it could happen "now or it could happen tomorrow or it could happen next week. Certainly time was important." Tr. 167. According to Customer LJ, MC told Customer LJ on that all of MC's information concerning the Merger came directly from Respondent 1.

Customer LJ did not speak directly to Respondent 1 until after Customer LJ began purchasing Company 1 stock. At some point in the Fall of 1993, Customer LJ became concerned about the Merger not occurring and repeatedly questioned MC about it. Customer LJ testified that during one conversation with MC, MC connected Respondent 1 on the line and MC, Respondent 1 and Customer LJ all discussed Customer LJ's concerns. Customer LJ testified vaguely that he spoke with Respondent 1 about the Merger, and he claimed that Respondent 1 told him the Merger would occur shortly. During one conversation, Respondent 1 allegedly told Customer LJ that "they were in their camp on this one." Tr. at 169, 174. Customer LJ further testified that during a conversation with Respondent 1, Respondent 1 told him, "I cannot tell you everything that I know, but if I could tell you everything that I know, you would not worry anymore." Tr. at 192, 193.⁴ Respondent 1 denied making these statements.

Customer LJ spoke with MC, not Respondent 1, about the Lawsuit. Customer LJ claimed that in late 1993 he telephoned MC intending to sell his Company 1 stock. MC encouraged Customer LJ not to sell the stock because Company 5 had filed the Lawsuit, worth \$580 million in a settlement, and Company 1's shareholders would receive \$10 per share in value. Although Customer LJ stated that MC always attributed his information to Respondent 1, Customer LJ was unsure of the source of MC's information about the Lawsuit.

Like Customer LJ, Customer MH purchased Company 1 stock in his personal account at Firm D based upon statements made to him by MC. In late June of 1993, Customer MH purchased 1,000 shares of Company 1 stock for 7 15/16 per share and in early July he purchased 2,000 more shares for 9 3/8 per share. Customer MH testified that MC told him that the Merger was going to occur, that Company 5 were involved in

⁴ The DBCC misconstrued Customer LJ's testimony regarding the impact of Respondent 1's statements on Customer LJ's trading of Company 1 stock. The DBCC opinion recites that Customer LJ sold 9,000 shares of Company 1 in October 1993 but that, "based on representations from Respondent 1 that 'he was in their camp,' he [Customer LJ] bought the 9,000 shares back a short time later." DBCC Opinion at 4. In fact, later in his testimony, Customer LJ acknowledged that it was MC's idea to sell the stock and repurchase it because the stock price was going to dip.

the stock, and that the share price could increase to \$10 to \$12 per share. MC attributed information about Company 1 stock to statements from Respondent 1. At one point, MC exhorted Customer MH to contact Customer MH's father, who was aboard a cruise ship at the time, by ship-to-shore telephone so that Customer MH's father would not miss the Company 1 buying opportunity. Customer MH sold the 3,000 shares on October 8, 1993 for \$10 per share, but re-purchased 2,000 for 10 1/8 per share just four days later.⁵

Customer MH claimed that the Lawsuit played a larger role than the Merger in his decision to purchase Company 1 stock. MC told Customer MH that when the Lawsuit settled, the stock then selling for approximately \$10 per share, could jump to \$18 to \$22 per share or the shareholders could receive a large cash dividend. MC also told Customer MH that the Lawsuit could be worth a particular amount to Company 1, but Customer MH could not recall that figure. Customer MH attempted to contact Respondent 1 directly, but never succeeded. Customer MH purchased 5,000 shares of Company 1 stock on November 4, 1993, three days after the Lawsuit was filed.

The last Firm D's customer to testify (via telephone) was Customer PH. Customer PH, a mortgage banker, was known to Firm D's employees as a sophisticated investor who had a very good grasp about companies' earnings and performance, and did extensive, independent research prior to purchasing securities. Although his account at Firm D was a personal account, Customer PH liked to "trade as an institution" because of the size of his trades, and he wanted access to Firm D's traders. Tr. at 205.

JW, Customer PH's account representative, had known Customer PH for at least 20 years and had transacted business with him for over 10 years. Customer PH was JW's biggest client, and JW spoke to Customer PH approximately three times per day. According to JW, Customer PH generally purchased one stock at a time, occasionally putting 100% of his investment in that one stock. JW stated that he would consider Customer PH a professional investor. JW indicated that Customer PH researched and followed the companies that he purchased very closely, went to annual meetings, and tried to speak directly with officers of the companies. JW stated that he did not believe that Customer PH could be easily misled.

JW sent Customer PH a monthly research paper that identified Respondent 1 as one of Firm D's analysts. Customer PH met Respondent 1 for the first time in New York City in September 1992. They spoke about Company 1 stock for the first time in May 1993. Customer PH recalled that at that time, Respondent 1 was excited about Company 1 because the value of the stock had risen significantly. Customer PH made his first purchase of Company 1 stock on June 9, 1993, before Respondent 1 and he began discussing the possibility of the Merger. Customer PH testified that Respondent 1 discussed the terms of the Merger using

⁵ The DBCC misconstrued Customer MH's testimony also. The DBCC recited that [MC] told [Customer MH] to repurchase the stock because Respondent 1 had told MC that the judge in the Lawsuit would make a decision soon and that the stock price would rise, or that the shareholders were going to get a one-time cash dividend as high as \$10 per share on the stock. Consequently, [Customer MH] stated that he purchased additional Company 1 stock within about a week of his selling it." In fact, the only time Customer MH repurchased Company 1 stock shortly after selling it was on October 12, 1993 -- three weeks before Company 5 filed the Lawsuit.

definitive statements. Customer PH stated that he had never known Respondent 1 to speculate because Respondent 1 was usually very sure about what he was discussing. Customer PH further stated that Respondent 1 indicated that the Merger would take place in a relatively short period of time (within six months).

Customer PH stated that he first learned about the Lawsuit during a telephone conversation with Respondent 1. According to Customer PH, Respondent 1 was always very clear that the settlement value of the Lawsuit would be for a great deal of money. Customer PH claimed that Respondent 1 told him that the value of the settlement to the Company 1 shareholders would be \$10 per share. According to Customer PH, Respondent 1 told him that the gross amount of the settlement in favor of Company 1 would be in the billions of dollars, "billions, with a 'b.'" Tr. at 335, 336. Customer PH stated that Respondent 1 told him that the Lawsuit had to be settled before the Merger could take place. Based on this information, Customer PH stated that he purchased additional shares of Company 1. According to Customer PH, he lost approximately \$2.3 million as a result of his purchases of Company 1 stock.

Based upon complaints by Firm D's customers, it appears that 20 accounts incurred losses as a result of purchases of Company 1 stock. Firm D has paid \$2.7 million to settle claims in 14 of the accounts. Customer LJ estimated that he lost \$60,000 as a result of his investment in Company 1. He filed a complaint against Firm D and received full reimbursement. Customer MH also filed a complaint against Firm D and claims that he was reimbursed for half of his losses in Company 1. Customer PH, who controls the remaining six accounts, filed a complaint in arbitration seeking compensatory damages of over \$2 million. On February 14, 1995, Firm D filed a Form RE-3 with the New York Stock Exchange, triggering the investigation that led to the issuance of the complaint in this case.

Discussion

Respondent 1's appeal raises three issues: (1) whether Respondent 1 made statements regarding the Merger and the Lawsuit for which he lacked a reasonable basis or that contained misrepresentations of material facts; (2) whether Respondent 1, in conversations with customers, encouraged the purchase or discouraged the sale of Company 1 stock and, if so, whether such conduct constituted active engagement in the securities business; and (3) whether Respondent 1 executed or caused to be executed a purchase of Company 1 stock in the account of Customer PH and, if so, whether such conduct constituted active engagement in the securities business. After carefully reviewing the record and statements on appeal, we answer each question negatively and, therefore, reverse the findings of the DBCC.

Misrepresentations

The first cause of the complaint alleged that Respondent 1 made misrepresentations regarding the Merger and the Lawsuit to Firm D's customers in violation of Conduct Rule 2110.⁶ A misrepresentation that

⁶ Conduct Rule 2110 provides that a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

violates Conduct Rule 2110 differs from a fraudulent misrepresentation that violates Conduct Rule 2120.⁷ To establish a fraudulent misrepresentation under Conduct Rule 2120 requires a finding of scienter.⁸

Scienter is not a prerequisite to a Conduct Rule 2110 violation based upon misrepresentation. Disciplinary hearings under Conduct Rule 2110 are ethical proceedings, and include violations of ethical requirements where no legally cognizable wrong occurred. In re Timothy L. Burkes 51 S.E.C. 356 (1993), aff'd mem., Burkes v. SEC, 29 F.3d 630 (9th Cir. 1994). The NASD has authority to impose sanctions for violations of "moral standards" even if the conduct was not "unlawful" or fraudulent. In re Benjamin Werner, 44 S.E.C. 622 (1971). The ethical standards imposed in disciplinary proceedings go beyond simple legal requirements and depend on general rules of fair dealing, the parties' reasonable expectations, marketplace practices, and the relationship between firms and customers. In re E.F. Hutton & Co., Inc., 49 S.E.C. 829 (1988). The crux of a Conduct Rule 2110 violation is the breach of a duty imposed by just and equitable principles of trade.

One such duty is the duty to make a reasonable investigation before making representations about securities. "A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents that he has an adequate basis for the opinions he renders." Hanly v. SEC, 415 F.2d 589, 595 (2d Cir. 1969). "A salesperson has a duty to make an adequate independent investigation in order to ensure that his representations to customers have a reasonable basis." In re Frank W. Leonesio, 48 S.E.C. 544, 548 (1986). "[A] salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. Regulators must protect the public not only from professionals in the business who practice deliberate deception, but also from those whose credulity and failure to investigate inflict equal harm on investors and undermine public confidence in the securities market to the same extent." In re Nassar & Co., Inc., 47 S.E.C. 20, 22 (1978).

Analysts such as Respondent 1 share this duty to investigate and to have a reasonable basis for their recommendations. Analysts that make representations without first conducting an adequate investigation and without first ensuring that they have a reasonable basis for that representation can injure the public as easily and as seriously as can a salesperson. Accordingly, we must determine whether Respondent 1 conducted a reasonable investigation and had a reasonable basis for making representations about the Merger and the Lawsuit.

⁷ Conduct Rule 2120 provides that 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.

⁸ Scienter has been defined as an "intent to deceive, manipulate or defraud" and includes a showing that the respondent acted recklessly. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); In re DWS Securities Corp., 51 S.E.C. 814 (1993). Recklessness is "not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990).

The reasonableness of Respondent 1's conduct is best understood in the context of his job responsibilities. As a research analyst, Respondent 1 was required: to initiate primary research coverage of companies that the Firm selected; to evaluate the companies' financial statements, operations, and management; and to issue research reports describing the investment potential and risks associated with an issuer's stock. In addition to analyzing the issuer's public filings, news articles, and products, an analyst will often meet with corporate officers, employees, and other insiders of the issuer, to question them about the company. The Supreme Court has applauded the analyst's role in "filling in the interstices of analysis" and has said that analysts perform a function that is "necessary to the preservation of a healthy market." Dirks v. S.E.C., 463 U.S. 646, 658 (1983). An analyst's ability to fill in these interstices, to make connections, and to draw inferences is the central requirement of his or her job. Therefore, we disagree with the DBCC's conclusion that Respondent 1's "reasoning is flawed in that it builds assumption upon assumption to come to the conclusion that the Merger would take place." (DBCC Opinion at 17).

The record does not establish that Respondent 1 breached his duty of reasonable investigation with respect to the Merger and the Lawsuit. Respondent 1 gave uncontroverted testimony describing how he pieced together: (1) Company 1's President's statements about a pooling; (2) the implications of Company 5's investment in Company 1; and (3) his experienced judgment that the two companies' operations could be combined to create extra value and reduce costs. Respondent 1 has documented these facts with notes of his meeting with Company 1's President, news reports of Company 2 former Chairman press conference, and evidence of Company 5's restructuring of a chain of Hotels.⁹ Accordingly, we disagree with the DBCC's conclusion that Respondent 1's "reasoning for believing that there was a merger is not based on verifiable facts."

In addition, two portfolio managers at Company 9 -- JSM and RD -- submitted notarized affidavits confirming the reasonableness of Respondent 1's analysis. Company 9 purchased Company 1 stock in mid-1992, well before Respondent 1 issued his first research report on Company 1, and held it until after the Lawsuit was filed. DM and RD could not recall how they first learned of the Merger possibility, although RD indicated that it was from an analyst other than Respondent 1. Both affidavits stated that Respondent 1's conclusions about Company 5's involvement and about the benefits of combining the two companies were logical and substantiated.

⁹ In fact, on August 12, 1993, a research analyst at Morgan Keegan issued a research report that described a circulating rumor about "the possibility of combining [Company 1] with [Company 2] . . . possibly through the purchase of the [Company 2's] former Chairman block of stock." The analyst concluded that the merger was unlikely to occur because Company 2's former Chairman would not sell his stock at the then-prevailing market price. He reiterated that conclusion in a September 28, 1993 research report.

Respondent 1 was also aware of rumors throughout the analyst community that Company 5 were interested in purchasing Company 2's former Chairman's Company 2 stock and that the two companies might merge. Learning of the existence of rumors, by itself, would not satisfy the duty of reasonable investigation shared by salespeople and analysts. In this case, however, Respondent 1 had sufficient knowledge apart from the rumors and integrated their existence into the mix of facts he had gathered.

Similarly, the record does not establish that Respondent 1 breached his duty of reasonable investigation with respect to the Lawsuit. Respondent 1's uncontroverted testimony establishes that he carefully analyzed the legal papers filed in the suit, consulted with independent analysts and counsel, and brought his experience to bear to assess the outcome of the case. Again, other analysts were investigating the Lawsuit and concluding that the Lawsuit had merit. Although the analysts differed in their opinions of Company 1's likelihood of success in the Lawsuit, Respondent 1's investigation was reasonable.¹⁰

The evidence does not support a finding that Respondent 1 made misrepresentations to customers about the Merger or the Lawsuit, as alleged in the complaint.¹¹ Nor was it a violation for Respondent 1 to express opinions about the Merger and the Lawsuit in "definitive" terms. The evidence establishes that Respondent 1 held strong opinions about Company 1 and that Respondent 1 forcefully expressed the analysis supporting his opinions. Even assuming that Respondent 1 made all the statements that are attributed to him, the record establishes that those statements are clearly recognizable as the opinions of an analyst and nothing more.¹²

Accordingly, we reverse the DBCC's findings of violation and dismiss cause one of the complaint.

¹⁰ Company 1 management also concluded that the Lawsuit had merit. When Company 1's President and other Company 1 executives retired from the company in January 1995, several of them exchanged valuable options and severance benefits for a financial interest in the outcome of the Lawsuit. These transactions indicate that Company 1's President believed that Company 1 stood to receive upwards of a \$100 million judgment against Company 4 and Company 7 in the Lawsuit.

¹¹ Respondent 1 could not have made misrepresentations to Customer MH because, according to Customer MH's own testimony, Customer MH never spoke with Respondent 1; Customer MH received all of his information about Company 1 from MC. Similarly, Customer LJ did not testify that he and Respondent 1 spoke about the Lawsuit; Customer LJ got his information about the Lawsuit from MC. Although Customer LJ and Respondent 1 did speak about the Merger, the evidence showed that it was MC who repeatedly opined that the Merger was imminent. Customer LJ's testimony, described above, that Respondent 1 said Firm D was "in their camp on this one" when referring to the Merger is equivocal and does Respondent 1 justify a finding of violation.

¹² The DBCC decision indicates that its finding of violation was based, in part, on two additional findings with which we take issue: (1) that Respondent 1's comments to Firm D's salespeople and customers were not first issued in a research report; and (2) that Respondent 1's conclusion rested on information not publicly available at that time. First, we are aware of no requirement that an analyst's communications are strictly limited to those pre-existing in research reports. Second, the record does not establish that Respondent 1 relied upon non-public information. Third, the complaint does not charge Respondent 1 with exceeding the scope of his research reports or misusing non-public information; it charges him only with making misrepresentations.

Registration

The complaint alleged that Respondent 1 violated Membership and Registration Rule 1031 in that he: (1) assisted Firm D's registered representatives in sales of stock of Company 1 by speaking directly with three customers -- Customer PH, Customer LJ, and Customer TA -- and encouraging them to purchase, or discouraging them from selling Company 1 stock; and (2) executed or caused to be executed a purchase of Company 1 stock in the account of customer Customer PH. For the reasons stated below, we reverse the DBCC's finding of violation.

Membership and Registration Rule 1031(a) states that "[a]ll persons engaged or to be engaged in the investment banking or securities business of a member who are to function as representatives shall be registered as such with the Corporation in the category of registration appropriate to the function to be performed." Section 1(b) defines "representatives" as "[p]ersons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions." Article I (k) of the NASD's By-Laws provides that "investment banking or securities business" means the business of "underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others."

The registration determination turns not on an individual's official title, but on whether he or she performs the functions of a representative. Functions performed by representatives include, but are not limited to, communicating with members of the public to determine their interest in making investments, discussing the nature or details of particular securities or investment vehicles, recommending the purchase or sale of securities, and accepting or executing orders for the purchase or sale of securities. See NASD Notice to Members ("NTM") 85-48 (July 1985) (personnel who solicit new accounts by telephone must register); NTM 88-24 (Mar. 1988) (personnel who accept orders from customers must register); and NTM 88-50 (July 1988) (personnel who make "cold-calls" must register). Therefore, research personnel who regularly communicate directly with customers, alone or accompanied by registered representatives, about particular securities or investment vehicles must register with the Association.¹³

In addition to this functional analysis, both the NASD and also the Securities and Exchange Commission ("Commission") consider the regularity with which an individual engages in activities reserved for registered representatives. For example, the registration of account solicitors is required because they "are assigned the specific function of interfacing with public customers on a regular basis." NTM 85-48 at 2 (emphasis added). In In re Exchange Services, Inc., the Commission held that order takers must register because "they will be in contact with the general public on a regular basis." 48 S.E.C. 210, 214 (1985) (emphasis added). Similarly, in In re Traiger Energy Investments, 48 S.E.C. 960 (1988), the Commission dismissed charges that a member firm

¹³ The concept of communicating with customers extends to the issuance and distribution of research reports where the author is identified by name. Although Respondent 1's research reports on Company 1 identified him by name and were distributed to customers, the complaint does not charge Respondent 1 with that violation.

violated NASD rules by failing to register individuals to whom it paid finders' fees because there was "no evidence that any finder repeatedly referred prospective purchasers of securities." 48 S.E.C. at 962 (emphasis added).¹⁴ In the wake of Traiger, the NASD proposed that members be permitted to pay fixed fees for referrals "on an occasional basis" provided that the fees are not linked to the outcome of the referral or to subsequent transactions. NTM 89-3 at 2 (emphasis added).

After careful consideration, we find the limited allegations of the complaint and the limited evidence adduced insufficient to sustain a finding of disciplinary violation as to cause two. While Respondent 1's activities did come within the class of functions requiring registration, in that he discussed the details of Company 1 stock with customers, the complaint alleged that he did so with only three customers. In fact, the record shows that: Respondent 1 spoke with only two customers during the relevant period; Respondent 1 did not initiate contact with these customers; Respondent 1 did not recommend the purchase or sale of Company 1 stock; and Respondent 1 did not receive commissions for the customers' purchase or sale of Company 1 stock.¹⁵ The record does not establish that Respondent 1 communicated with customers on a regular basis.

Nor does the evidence establish that Respondent 1 executed or caused to be executed a purchase of Company 1 stock in Customer PH's account. Respondent 1 and Customer PH traveled to New York and Louisville together on July 9, 1993, during which trip they discussed Company 1. Customer PH's account records show that 54,400 shares of Company 1 settled in his account on July 16, 1993, indicating that the trade occurred on July 9. The DBCC found that Customer PH "testified that [Respondent 1] was the one who placed the purchase order through [a Firm D market maker]." DBCC Opinion at 6.¹⁶ In fact, Customer PH

¹⁴ Another important factor in determining whether an associated person must register is the receipt of sales commissions. Any compensation that depends upon the sale of securities, the volume of sales, the success of a solicitation or referral, or the execution of a transaction will require that the recipient register with the Association. See NTM 89-3 (Jan. 1989) (persons who receive "finders" fees for introducing or referring prospective customers are engaged in the securities business in the form of solicitation). Conversely, salaried or hourly-wage employees are less likely to be required to register.

¹⁵ Representatives cannot shift their regulatory responsibilities to their firms. We note, however, that Firm D's Director of Research had consulted with Firm D's compliance department and had advised Respondent 1 that he did not need to register with the Association. When Respondent 1's supervisor became aware that Respondent 1 had spoken with customers about Company 1 stock, she took no action because she considered that to be "part of his service to the customers at [Firm D]." Tr. at 284-285. While some evidence prepared by Firm D indicated that Respondent 1 may have had contacts with other customers, the complaint alleged contacts with only three customers and contacts with only two customers were established.

We affirm the Association's longstanding position that research personnel engaged in regular communication with the public must qualify and register as representatives of their member firms. Our determination is limited to the unique facts and circumstances of this case and should not be interpreted to establish an exception to the general rule we have restated.

¹⁶ Although the Firm D trader, the Company 1 market maker at Firm D, JW, and Respondent 1 all denied

simply testified that Respondent 1 placed a telephone call to the Company 1 market maker at Firm D, and then handed the phone to Customer PH:

When I was in Louisville with [Respondent 1] at Grow Group, we were walking through the research lab one day, and he stopped to make a phone call and then he handed me the phone, and it was [the Company 1 market maker at Firm D] on the line, and [he] said, 'Hey, [Respondent 1] tells me you want to buy more Company 1 stock, and I've got ten thousand' or something like that. We didn't have time to do it that moment, but later in the day I did.

Tr. at 339 - 40. Customer PH also testified that he and the Company 1 market maker at Firm D knew and had dealt directly with each other prior to July 1993. In these circumstances, we cannot find that Respondent 1 executed or caused to be executed a trade in Company 1 stock.

Conclusion

Having reversed the DBCC's findings of violations on both causes of the complaint, we eliminate all sanctions imposed against Respondent 1.¹⁷

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

that Respondent 1 executed a trade or caused it be executed on Customer PH's behalf, the DBCC found Hudson's testimony to be more credible, because Customer PH "had no reason to mislead the panel," whereas the Firm D trader and the Company 1 market maker at Firm D had such a reason because they were still Firm D employees. DBCC Opinion at 19. Given Customer PH's on-going multi-million dollar arbitration based on Respondent 1's alleged misconduct and the potential for disciplinary action against the Firm D trader and the Company 1 market maker at Firm D for giving untruthful testimony in an NASD proceeding, this finding is questionable.

¹⁷ 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.