

BEFORE THE NATIONAL ADJUDICATORY COUNCIL  
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of the  
New Membership Application  
Firm X,  
City 1, State 1

DECISION

Application No.

Dated: May 4, 2015

**Department of Member Regulation denied a firm's application  
for membership. Held, denial affirmed.**

**Appearances**

For Firm X: Attorney 1

For FINRA's Department of Member Regulation: Ann-Marie Mason, Esq., Deon McNeil-Lambkin, Esq., Sarah Razaq, Esq.

**Decision**

Pursuant to NASD Rule 1015(a), Firm X appeals an October 3, 2014 decision by the Department of Member Regulation ("Member Regulation") denying Firm X's application for membership based on its finding that Firm X failed to satisfy five of the 14 standards for membership established under NASD Rule 1014(a). After conducting a two-day hearing and reviewing the record, we affirm the denial of membership.

I. Background

Firm X organized as a limited liability company in State 1 in 2013. Firm X is wholly owned by Parent Company, a limited liability company in State 1, which is wholly owned by Principal 1.

Principal 1 entered the securities industry in 1985 and has associated with several firms. Principal 1 passed the Series 6 (investment company products and variable contracts representative) examination in December 1985; the Series 7 (general securities representative) examination in April 1986; the Series 22 (direct participation program limited representative) examination in January 1986; the Series 63 (uniform securities agent state law) examination in February 1986; and the Series 65 (uniform investment adviser law) examination in September 2012. He was granted an official waiver of the Series 24 (general securities principal) examination in June 1991.

## II. Relevant Facts

### A. Principal 1's Termination for Cause

From December 1994 to August 2010, Principal 1 worked as a general securities representative and principal for Firm Y. While at Firm Y, Principal 1 had approximately 500 customer accounts under management. Of those 500 accounts, approximately 90 percent were invested in variable annuities and Real Estate Investment Trusts ("REITs"), and 70 percent employed a 72(t) distribution strategy because of liquidity needs.<sup>1</sup> In 2010, Principal 1's supervisor at Firm Y sent a letter of caution to Principal 1 stating that Principal 1 submitted variable annuity paperwork to product sponsor companies prior to receiving pre-approval, as required by the firm's sales practice manual. After receiving the letter of caution, Principal 1 submitted all of the required variable annuity pre-approval paperwork, but Firm Y did not approve any of the sales because it found them unsuitable or over-concentrated in variable annuities.

The Central Registration Depository ("CRD"®) reflects that Firm Y discharged Principal 1 on August 26, 2010, for the "failure to abide by firm policy regarding the pre-approval of variable annuities."<sup>2</sup>

### B. Firm X's Initial Application

On January 6, 2014, Firm X filed with Member Regulation its form New Member Application ("NMA") and supporting documentation, seeking FINRA approval to register as a broker-dealer. The application included Firm X's proposed business plan and written supervisory procedures ("WSPs"). Firm X stated "it would conduct a general securities business focusing on the sale of variable life insurance policies and the sale of [REITs]." Specifically, Firm X represented that it would engage in the following business activities: broker retailing corporate equities securities; broker retailing corporate debt securities; mutual fund retailer;

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<sup>1</sup> Section 72(t) of the Internal Revenue Code imposes an additional tax of 10 percent on distributions from qualified retirement plan made before age 59 ½. The IRS allows retirees to avoid this 10 percent penalty if the distributions from the retirement plan "are part of a series of substantially equal periodic payments."

<sup>2</sup> Principal 1's termination for cause is discussed in more detail in Part III.C.1.

broker selling variable life insurance or annuities, U.S. government securities broker; broker selling tax shelters or limited partnerships in primary distribution or in the secondary market; and the purchase and sale of REITs. Firm X said it would solicit retail customers, and it would not handle customer funds.

Firm X represented that Principal 1 would serve as Firm X's Chief Executive Officer ("CEO"), Chief Compliance Officer ("CCO"), Anti-Money Laundering Compliance Officer ("AMLCO"), and only representative. Principal 1 sought to register with Firm X as a general securities principal and investment company products and variable contracts representative, general securities representative, and direct participation program limited representative. Principal 2 would serve as Firm X's financial and operations principal ("FINOP") on a part-time basis at an offsite location. At the time of Member Regulation's decision, Principal 2 was serving as FINOP for five other FINRA member firms.

The initial application did not disclose Principal 1's termination for cause, any customer complaint against Principal 1, or any arbitration that named Principal 1 as a respondent.<sup>3</sup> In fact, as of January 6, 2014, seven customer complaints had been filed against Principal 1 alleging improprieties involving the sale of variable annuities and REITs while Principal 1 was working at Firm Y. In addition, Principal 1 was a named respondent in an arbitration filed in 2013, claiming that he failed to supervise another broker, who was alleged to have made unsuitable recommendations concerning variable annuities and REITs.<sup>4</sup>

C. Member Regulation's Review of Firm X's New Member Application

1. Member Regulation's Requests for Additional Information and Firm X's Responses

In a letter dated February 14, 2014, Member Regulation requested additional supporting information and documentation in connection with the application. Among other things, Member Regulation notified Firm X that Principal 1 was terminated for cause on August 26, 2010, and requested that Firm X submit a detailed explanation about how it believed it overcame the presumption of denial triggered by Principal 1's termination for cause, including demonstrating how Firm X believed it met the standards set forth in NASD Rule 1014.<sup>5</sup>

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<sup>3</sup> The NMA asks whether the applicant or any of its associated person is the subject of "[a] sales practice event, pending arbitration or pending private civil action" or "[t]ermination for [c]ause or permitted to resign after an investigation after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct." In each version of the NMA it filed, Firm X checked "No."

<sup>4</sup> By the time Member Regulation issued its decision letter, 23 complaints in total had been filed against Principal 1, and he was a respondent in three pending arbitrations.

<sup>5</sup> We discuss the presumption of denial in Part III.A.

Member Regulation also requested a detailed explanation of the customer complaints against Principal 1 provided in CRD that alleged unsuitable transactions in variable annuities and REITs. Member Regulation also sought clarification whether Principal 1 would be subject to heightened supervision at Firm X, who would oversee his activities, and whether Firm X was relying on the limited size and resources exemption pursuant to NASD Rule 3012.<sup>6</sup>

Firm X responded in two parts. On April 14, 2014, Firm X provided detailed information about the seven customer complaints. Then by letter dated May 8, 2014, in response to staff's question concerning Principal 1's termination for cause and customer complaints, Firm X wrote, "[t]he [NASD Rule] 1014 documentation and information concerning Principal 1, the only member with any matters to disclose, has already been provided in separate explanations regarding the customer disputes and the termination." Whereas Firm X had previously provided detailed information about the seven customer complaints on April 14, 2014, Firm X did not provide any explanation about how it believed it overcame the presumption of denial based on Principal 1's termination for cause.<sup>7</sup> Further, despite language in Firm X's WSPs that would require heightened supervision, Firm X wrote that Principal 1 would "not be subject to heightened supervision" because "[Firm X] only employs Principal 1 as the sole representative." Finally, Firm X stated it would be relying on the limited size and resources exemption pursuant to NASD Rule 3012, and it also would be using an outside compliance firm, Company Z, to assist in meeting daily compliance obligations.<sup>8</sup>

Member Regulation staff sent two additional written requests to Firm X, to which Firm X responded in writing. Member Regulation staff and Firm X also had approximately 10 conversations during the pendency of the application. Firm X filed 10 versions of the NMA. In each of the versions, Firm X failed to disclose Principal 1's termination for cause or the initial arbitration filed against Principal 1 in 2013.<sup>9</sup>

## 2. Additional Customer Complaints

After Firm X submitted its initial application, 16 more customer complaints were filed against Principal 1 in addition to the seven existing complaints against Principal 1. The

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<sup>6</sup> We discuss NASD Rule 3012 in Part III.D.1.

<sup>7</sup> Member Regulation staff testified that they never received further documentation or written explanation concerning Principal 1's termination for cause or how Firm X believed it overcame the presumption of denial.

<sup>8</sup> Company Z and its consultant also assisted Firm X with the submission and consideration of its application for membership.

<sup>9</sup> Principal 1 testified at the hearing that the application was inaccurate due to a clerical error by staff helping him prepare the documents. He further testified that Firm X was in constant contact with FINRA, so he was certain they were aware of the issues.

additional 16 complaints similarly alleged improprieties involving the sale of variable annuities and REITs.

Specifically, six customers of Principal 1 joined a multi-party FINRA arbitration proceeding, claiming breach of fiduciary duty, false representations, and failure to supervise. The statement of claim alleges that Principal 1 and his associate, Employee 1, whom Principal 1 supervised, solicited retired Company 1 employees or Company 1 employees nearing retirement and recommended that they take lump sum distributions from their IRA and 401(k) plans and invest the funds in variable annuities and REITs. Eight other customers became part of another multi-party FINRA arbitration and another six customers became part of a multi-party action in County 1, State 1.<sup>10</sup>

Member Regulation staff already had concerns about the existing customer complaints with respect to its initial review of the application, and the additional complaints and arbitrations only intensified its reservations concerning approval of the application because they considered Principal 1's regulatory history to be evolving. Member Regulation staff raised these concerns with Firm X during multiple telephone conversations and suggested that Firm X withdraw its application. Firm X's consultant from Company Z acknowledged to FINRA the concerns and their negative implications for approval of Firm X's application. Principal 1 also told FINRA he understood the concerns, but he did not want to withdraw the application.

### 3. Firm X's Membership Interview

On August 6, 2014, Member Regulation staff, along with the surveillance director, associate director, and regulatory coordinator at the FINRA District Office, conducted a membership interview of Firm X. Principal 1 and Firm X's consultant appeared in person, and Principal 2 participated telephonically.

At the interview, Member Regulation staff again expressed its concerns about Principal 1's termination for cause and Firm X's failure to rebut the presumption that the application should be denied; the numerous customer complaints filed against Principal 1, the subject of which were the very same business lines proposed by Firm X; and the proposed supervisory structure at Firm X, whereby Principal 1 would not be subject to heightened supervision and would be supervising himself in the very same business lines that led to 23 customer complaints being filed against him. Member Regulation staff also testified that Principal 1 was unable to articulate basic suitability concepts at the interview.

Principal 1 stated that his termination was due to a falling out with his manager at Firm Y, but he admitted he violated firm policy regarding the pre-approval of variable annuities. He asserted he did so because Firm Y's review process was taking too long, and, as a general securities principal, he could approve the transactions.

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<sup>10</sup> As of the date of this decision, all three multi-party proceedings are currently pending.

After the interview, Member Regulation staff and Firm X's consultant again spoke by telephone, and Member Regulation staff reasserted its belief that Firm X should withdraw its application. According to Member Regulation staff, the consultant agreed with the recommendation.

D. Member Regulation's Denial of Firm X's New Membership Application

After Firm X failed to withdraw its application for new membership, Member Regulation issued its decision denying Firm X's application on October 3, 2014. Member Regulation based its denial on several factors.

First, Member Regulation found that Firm X failed to meet the standards in NASD Rule 1014(a)(9) and (10), which require adequate compliance, supervisory, operational, and internal control practices and standards and an adequate supervisory system, including WSPs, internal operating procedures, and compliance procedures designed to prevent and detect violations of federal securities laws, the rules and regulations thereunder, and FINRA rules. Specifically, Member Regulation found problematic Principal 1's role in the supervisory structure. Principal 1 would engage in the very same lines of business that he engaged in at Firm Y that led to 23 customer complaints being filed against him but with a less rigorous supervisory structure in which he supervised himself. Member Regulation also found that Firm X's intent to not place Principal 1 under heightened supervision—in spite of requirements in Firm X's WSPs due to Principal 1's relevant regulatory history—resulted in Firm X's inability to satisfy NASD Rule 1014(a)(10). Member Regulation further found that Firm X's intent to not enforce its own WSPs to evidence a culture of non-compliance.

Second, Member Regulation found that Firm X failed to meet the standard in NASD Rule 1014(a)(3), which requires Firm X and its associated persons to be capable of complying with federal securities laws, the rules and regulations thereunder, and FINRA rules. Member Regulation based this conclusion on Principal 1's termination for cause by Firm Y and the fact that, despite inquiry by Member Regulation, Firm X never specifically addressed the resulting presumption of denial. Member Regulation also based this conclusion on the fact that Principal 1 was the subject of a pending arbitration at the time the application was filed (which Firm X failed to disclose) and three additional multi-party arbitrations filed during the pendency of the application.

Third, Member Regulation found that Firm X failed to meet the standard in NASD Rule 1014(a)(13) because Member Regulation possessed additional information that Firm X may circumvent, evade, or otherwise avoid compliance with the federal securities laws, rules and regulations, and FINRA rules. Member Regulation took into account Principal 1's termination for cause, the customer complaints filed against Principal 1, the arbitrations naming Principal 1 as a respondent, Firm X's failure to disclose the termination for cause and the initial arbitration in his application, and Principal 1 being the subject of a FINRA cause examination.<sup>11</sup> Member

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<sup>11</sup> We address the on-the-record interview of Principal 1 that was conducted pursuant to the FINRA cause examination in Part III.B.1.

Regulation noted that, while not adjudicated, the serious nature of the allegations in the complaints and arbitrations, along with the nexus between Principal 1's role at Firm Y and his intended role at Firm X and the activities to be conducted at Firm X compelled Member Regulation to conclude that the standard had not been met.

Finally, Member Regulation found that Firm X failed to meet the standard in Rule 1014(a)(1), which requires the membership application and all supporting documents to be complete and accurate. Among other things, Member Regulation noted that Firm X failed to disclose on the Form NMA Principal 1's August 2010 termination for cause, customer complaints, and the arbitration pending at the time.

#### E. Firm X Requests a Review of Member Regulation's Decision

On October 27, 2014, Firm X filed a written request that we review Member Regulation's denial of its membership application pursuant to NASD Rule 1015(a). On January 12-13, 2015, a subcommittee ("Subcommittee") of the National Adjudicatory Council ("NAC") empaneled to hear this matter presided over an evidentiary hearing. Firm X submitted six exhibits and presented two witnesses: Principal 1 and Firm Expert. Member Regulation submitted 32 exhibits and presented four witnesses: (1) Member Regulation Witness 1, Principal Examiner, FINRA's Membership Application Program; (2) Member Regulation Witness 2, Examination Manager, FINRA's Membership Application Program; (3) Member Regulation Witness 3, Director, FINRA's Membership Application Program; and (4) Member Regulation Witness 4, Surveillance Director, FINRA's District Office. At and following the hearing, Firm X moved to adduce two additional documents, which Member Regulation opposed.<sup>12</sup>

### III. Discussion

#### A. Relevant Standards

NASD Rule 1014(a) delineates 14 standards that an applicant must meet before Member Regulation may approve a request for membership admission. In general, the standards in NASD Rule 1014(a) are intended to ensure that members are capable of satisfying all relevant regulatory requirements for the protection of the investing public, the securities markets, the firm, and other member firms. *See Membership Continuance Application of Member Firm*, Application No. 20060058633, 2007 FINRA Discip. LEXIS 31, at \*44-45 (FINRA NAC July 2007). When assessing whether an applicant for membership meets these standards, the rule requires Member Regulation to consider, among other things, "the public interest and protection of investors." NASD Rule 1014(a). The applicant bears the burden of demonstrating that it meets each of the standards for membership approval. *See New Membership Application of Firm A*, Application No. 20090182345, 2010 FINRA Discip. LEXIS 24, at \*22 (FINRA NAC Sept. 28, 2010); *see also* NASD Rule 1014(a), (b). Member Regulation found that Firm X failed to demonstrate it could meet five of the standards articulated in NASD Rule 1014(a). We affirm

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<sup>12</sup> We address these two additional documents in Part III.C.1.

Member Regulation's findings that Firm X failed to carry its burden to demonstrate that it has satisfied the standards set forth in NASD Rule 1014(a)(3), (9), and (10).<sup>13</sup>

Under NASD Rule 1014(b), where a prospective member firm or an associated person is subject to certain events set forth in the rule, including a termination for cause after an investigation of alleged violation of an industry standard of conduct, "a presumption exists that the application should be denied." The existence of such an event "[raises] a question of capacity to comply with the federal securities laws and the rules of [FINRA]," which results in a rebuttable presumption to deny the application. *See NASD Notice to Members 04-10, 2004 FINRA LEXIS 13, at \*9 (Feb. 2004)*. Member Regulation argues that following firm policy is an industry standard, thus Principal 1's termination for cause for the failure to abide by firm policy regarding the pre-approval of variable annuities triggers the rebuttable presumption pursuant to NASD Rule 1014(b) that the application should be denied. We agree that a termination for cause for failing to follow a firm's relevant and material sales practice policy is a violation of an industry standard that triggers the rebuttable presumption.

An applicant "may overcome the presumption by demonstrating that it can meet each of the standards in [NASD Rule 1014(a)]," notwithstanding the existence of the event. NASD Rule 1014(b). In considering whether an applicant has overcome the presumption, Member Regulation is directed to "consider the applicant's submission in light of the specific standards of Rule 1014(a), the public interest, protection of investors, and [FINRA]'s responsibility to provide a fair procedure in accordance with membership rules." *See NASD Notice to Members 04-10, at \*11*. In its decision letter, Member Regulation concluded that Firm X failed to rebut the presumption based on Firm X's failure to specifically address the presumption despite its requests and Principal 1's testimony at a March 13, 2014 on-the-record interview that he was intimately involved in all aspects of the business at Firm Y, including Employee 1's sales of variable annuities and REITs.<sup>14</sup> In our review, we have conducted the same analysis.

Throughout the pendency of the application, Firm X argued that Principal 1 was not terminated for cause and, regardless whether he was terminated for cause, that its application for membership met the standards set forth in NASD Rule 1014. For example, in its notice of appeal, Firm X argued that, notwithstanding the termination for cause, "[Firm X] is committed to moving forward" and engaged the services of a compliance consulting firm, [Company Z]." Firm X continued, "[g]oing forward, [Firm X] is committed to proving it will strive to improve

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<sup>13</sup> In light of our findings that Firm X failed to satisfy these standards, it is unnecessary to discuss further whether Firm X's application was "complete and accurate," as required by Rule 1014(a)(1), and whether there is information indicating Firm X may circumvent, evade or otherwise avoid compliance with applicable securities laws, rules, and regulations and FINRA rules, as required by NASD Rule 1014(a)(13).

<sup>14</sup> Member Regulation staff also testified that Firm X did not adequately address questions related to his termination for cause and the resulting rebuttable presumption at the membership interview or during telephone conversations while the application was pending.

its compliance with securities laws and regulation wherever possible.” At the hearing, in response to questioning about the rebuttable presumption, Principal 1 also referred to a November 4, 2010 letter he purportedly emailed to FINRA explaining the circumstances surrounding his termination for cause.

For reasons explain below, we conclude that Principal 1 was terminated for cause for purposes of NASD Rule 1014(a)(3)(D), thus triggering a presumption that the application should be denied. Fair procedure requires us, notwithstanding the existence of the termination for cause, to consider all of Firm X’s submissions with respect to the specific standards of Rule 1014(a), the public interest, and protection of investors. After thorough review, we find that Firm X failed to overcome the presumption of denial. Firm X failed to demonstrate it could meet the standards set forth in NASD Rule 1014(a)(3), (9), and (10). Firm X failed to show that Principal 1, at this time, is capable of complying with federal securities laws, the rules and regulations thereunder, and FINRA rules; and Firm X’s supervisory practices, standards, and system failed to adequately account for Principal 1’s recent and relevant regulatory history to ensure compliance with federal securities laws, the rules and regulations thereunder, and FINRA rules.<sup>15</sup>

B. Procedural Arguments

Prior to discussing the relevant standards in NASD Rule 1014(a), we address the parties’ procedural arguments concerning Principal 1’s on-the-record interview testimony and Firm X’s proposed expert.

1. March 13, 2014 On-the-Record Interview of Principal 1

In its decision letter denying Firm X’s application, Member Regulation relies, in part, on a March 13, 2014 on-the-record interview (“OTR”) of Principal 1 by Member Regulation. According to Member Regulation, the OTR was given as part of an on-going cause examination as the result of a customer complaint concerning Principal 1’s sales of REITs while at Firm Y. Firm X argues that Member Regulation’s reliance on the OTR is improper because “[t]he testimony was never raised by FINRA during the application process, and Staff did not provide in its decision letter any of the recorded testimony used to draw their conclusions.”

NASD Rule 1013(b)(7) provides:

During the membership interview, [Member Regulation] shall provide to the Applicant’s representative . . . any information or document that the Department has obtained from . . . a source other than the Applicant and

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<sup>15</sup> Even if we were to conclude that the rebuttable presumption was not triggered in this instance, we nonetheless find that Firm X, which bears the burden of demonstrating that it meets each of the standards for membership approval, failed to demonstrate it could meet the standards set forth in NASD Rule 1014(a)(3), (9), and (10). See *New Membership Application of Firm A*, 2010 FINRA Discip. LEXIS 24, at \*22.

upon which the Department intends to base its decision under Rule 1014. If [Member Regulation] receives such information or document after the membership interview or decides to base its decision on such information after the membership interview, the Department shall promptly serve the information or document and an explanation thereof on the Applicant.

We find that Member Regulation erred and should have produced the OTR transcript at the membership interview or thereafter when it decided to base its decision upon it.

We find, however, any error was harmless. Principal 1, and in turn Firm X, was not unaware of the contents of the OTR. Indeed, it was the OTR of Principal 1, the de facto owner of Firm X and its only representative, which was conducted during the pendency of Firm X's application for membership. We fail to see any unfairness in Member Regulation considering Principal 1's sworn testimony when evaluating Firm X's NMA. We disagree with Firm X's argument that the authors of the decision letter denying the application needed to be present at the OTR in order for the transcript to be reliable. Likewise, the fact that Principal 1 has yet to be charged with any violation as a result of the OTR does not make the transcript unreliable. Principal 1, who was represented by counsel, received proper notice of his requested testimony pursuant to FINRA Rule 8210, was properly sworn in at the OTR, and testified under oath in the presence of a court reporter. Following the OTR, Principal 1 could have reviewed a copy of the transcript or requested, in writing, a copy of the transcript. *See* FINRA Rule 8210(f); *FINRA Regulatory Notice 09-17*, 2009 FINRA LEXIS 45, at \*4 (Mar. 2009). Moreover, after receiving Firm X's notice of appeal, Member Regulation provided copies to Firm X's counsel of all the documents that were considered in connection with its decision letter, including the OTR transcript, on November 10, 2014—more than two months in advance of the hearing. Therefore, Firm X had the ability to review the transcript in detail and present evidence and question witnesses, including Principal 1, at the hearing about the subject matter and events surrounding Principal 1's testimony. *See Sierra Nevada Sec., Inc.*, 54 S.E.C. 112, 120-122 (1999) (finding FINRA's failure to produce a draft letter to the applicant firm that FINRA relied on in connection with its denial of an application for membership was harmless because the letter contained no independent, new information and those responsible for the draft letter were examined by the applicant firm at the hearing).

## 2. Firm X's Proposed Expert Witness

In its witness list, Firm X stated it planned to call two witnesses: Principal 1 and "Firm Expert, expert witness."<sup>16</sup> Member Regulation filed a written objection to Firm Expert's testimony, arguing that expert testimony was beyond the scope of the proceeding, his testimony would unnecessarily prolong the hearing, and Firm X's notice of its intent to call a witness was deficient because it did not proffer the scope of Firm Expert's testimony or his qualifications as an expert. Firm X filed a written response, in which it argued, among other things, that it advised Member Regulation of its intent to present expert testimony in its notice of appeal, a

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<sup>16</sup> Pursuant to the scheduling order, the parties exchanged witness and exhibit lists five days prior to the hearing.

formal motion for leave to present expert testimony is not required, and Firm Expert's testimony was relevant and not duplicative. Later, Firm X asserted that Firm Expert was expected to testify to "the relevance and the application of NASD Rule 1014, [Principal 1's] qualifications, as well as the various applicable rules and regulations pertaining to [Principal 1's] circumstances and [Member Regulation's] interpretation of them."

FINRA and NASD rules relevant to membership proceedings do not address the provision of expert testimony. The Subcommittee for the NAC empanelled to hear the matter allowed Firm Expert to testify but reserved its right to deem Firm Expert an expert and to determine the scope and weight, if any, afforded to his testimony.

Firm Expert entered the securities industry in 1984 and has associated with several firms. Firm Expert passed the Series 7 examination in February 1998; the Series 24 examination in March 1998; the Series 27 (financial and operations principal) examination in April 1989; the Series 53 (municipal securities principal) examination in May 2001; the Series 55 (limited representative – equity trader) examination in September 2000; and the Series 63 examination in July 1989. As of the hearing, he was registered with 15 firms in a variety of capacities.

At the hearing, Firm Expert testified that he had worked in the financial services industry for more than 30 years and as a chief compliance officer for 15 years. His resume did not reflect any experience with membership applications, but he testified that he had worked on approximately five to 10 new membership applications and "numerous" continuing membership applications, in the capacity of a FINOP, chief compliance officer, or a consultant for the applicant firms. With regard to these applications, Firm Expert testified that a subordinate or someone he hired prepared the applications and he would act as a "quarterback" and supervisor during the membership application process.

Firm Expert testified that he spent approximately eight hours preparing to testify. He further testified that he did not review the record in this matter, did not review any version of the NMA submitted by Firm X, or any correspondence between Firm X and Member Regulation during the application process. In fact, other than the decision letter, two of the 27 customer complaints, and FINRA's BrokerCheck, he was unable to recall with any specificity what documents he reviewed to prepare to testify.

Based on the record, we find that Firm Expert does not qualify as an expert in this proceeding. Among other things, Firm Expert lacked familiarity with NASD Rule 1014, and we find his experience does not qualify as expertise in the area of membership applications and proceedings. Even if we were to find that Firm Expert was an expert, we find that he lacked the necessary foundation to opine on the matter because he never reviewed, among other things, any version of the NMA or any correspondence between Firm X and Member Regulation during the application process. Accordingly, we afford no weight to the testimony of Firm Expert.

C. Firm X Failed to Demonstrate that It Satisfied the Standard of NASD Rule 1014(a)(3)

NASD Rule 1014(a)(3) requires that Member Regulation determine whether “[t]he Applicant and its Associated Persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and NASD [and FINRA] Rules, including observing high standards of commercial honor and just and equitable principles of trade.” Member Regulation found that Firm X failed to meet the standard based on Principal 1’s termination for cause and the arbitrations pending against him. For the reasons explained below, we agree.

1. Principal 1’s Termination for Cause

NASD Rule 1014(a)(3) instructs Member Regulation, when determining whether the standard has been met, to consider whether “an [a]ssociated [p]erson was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct.” NASD Rule 1014(a)(3)(D). Member Regulation found that Principal 1 was terminated for cause by Firm Y on August 26, 2010, as reflected by a Uniform Termination Notice for Securities Industry Registration (“Form U5”) filed by the firm on September 2, 2010. Firm X disputes this conclusion. It argues that Principal 1 was not terminated for cause because Principal 1 tendered his letter of resignation and it was received by Firm X prior to his termination for cause. Firm X also argues that Firm Y filed a false Form U5 stating that Principal 1 was terminated in retaliation for Principal 1 resigning and taking his large of book of business away from the firm.<sup>17</sup> Firm X, relying on BrokerCheck, also argues that Firm Y updated Principal 1’s Form U5 prior to the hearing to reflect that Principal 1 was not terminated for cause.

a. The Evidence Does Not Support that Principal 1 Resigned Prior to Being Notified that He Was Going to Be Terminated

Firm X argues that Principal 1 resigned prior to being terminated, so he was not terminated for cause. We disagree. The preponderance of the evidence supports that Principal 1 tendered his letter of resignation only after being told he was being terminated for cause. Indeed, Firm X does not argue, or even suggest, that Principal 1 resigned prior to being notified that he was going to be terminated. Under these circumstances, we find an associated person’s resignation prior to a forthcoming termination for cause does not negate a firm’s termination for cause and its collateral consequences with respect to NASD Rule 1014(a)(3).

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<sup>17</sup> Firm X further argues that, following Firm Y’s “retroactive” termination of Principal 1, the firm began a “mailing campaign” directed at Principal 1’s clients explaining the risks and downsides associated with variable annuities and informing them of Principal 1’s “termination” for variable annuity violations.

In support of its argument that Principal 1 tendered his letter of resignation prior to his termination for cause, Firm X relies on a letter dated August 20, 2010, from Principal 1 addressed to the Compliance Department at Firm Y in City 2, State 2, which reads, “Consider this letter notification of my resignation effective August 25, 2010.” Firm X argues that Principal 1 mailed this resignation letter on August 26, 2010, and it was received on August 27, 2010, as evidenced by a FedEx tracking update email. First, we note that the FedEx tracking update email provides that correspondence was sent to Firm Y Supervisor in City 3, State 3, not the Firm Y Compliance Department in City 2, State 2, as provided in the letter.<sup>18</sup> Firm X did not explain this discrepancy. More importantly, at the March 13, 2014 OTR, Principal 1 never mentioned his August 25, 2010 resignation letter when asked to explain the circumstances surrounding his termination from Firm Y. Instead, Principal 1 testified that, prior to receiving a copy of the Form U5, he was told by Firm Y that he “was going to be terminated for cause.” Principal 1 did not dispute his testimony at the hearing.

At the hearing, Principal 1 further testified that he previously provided information to FINRA concerning his termination for cause, and Firm X moved to adduce a document—a November 4, 2010 letter without any delivery confirmation—that Principal 1 testified that he emailed to FINRA in response to an inquiry about his termination for cause. According to Firm X, the November 4, 2010 letter explains the “circumstances surrounding Principal 1’s sale of variable annuities while associated with Firm Y which culminated in his eventual resignation at the firm.” Firm X admits that it does not possess any documentation to authenticate the document or prove that FINRA received it, but argues that any existing evidence to authenticate the document or prove receipt would be in FINRA’s custody and control. Member Regulation opposed Firm X’s motion, arguing that Firm X failed to prove that Principal 1 emailed the document to FINRA and that the document was irrelevant.

Pursuant to NASD Rule 1015(f)(3) and the applicable scheduling order, the parties were required to exchange exhibit lists five days prior to the hearing. Firm X did not include the November 4, 2010 letter, so the Subcommittee must exclude it unless it “determines that good cause is shown for failure to comply with the production date.” NASD Rule 1015(f)(3). Firm X has not demonstrated that good cause exists for its failure to include the November 4, 2010 letter on its exhibit list. Even assuming arguendo that the letter is authentic, the document was in existence and in Firm X’s possession at the time the parties exchanged their exhibit lists. Firm X, who was represented by counsel, should have foreseen that the circumstances surrounding his termination for cause, the rebuttable presumption, and compliance with Member Regulation’s requests for information during the application process would be a subject of scrutiny at the hearing, and therefore should have included on its exhibit list any document that would have supported its assertions. Nevertheless, we considered the substance of letter and conclude that, if anything, it supports that Principal 1 was terminated for cause because the letter does not suggest that Principal 1 resigned prior to being notified that he was going to be terminated.<sup>19</sup>

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<sup>18</sup> Firm Y Supervisor was Principal 1’s direct supervisor at Firm Y.

<sup>19</sup> According to the 2010 letter, Principal 1’s supervisor at Firm Y, Firm Y Supervisor telephoned Principal 1 on July 25, 2010, and said that, “I was being terminated for cause; that

b. The Evidence Does Not Support that Firm Y Filed a False Form U5

We find there is no evidence to suggest that Firm Y filed a false Form U5 in retaliation for Principal 1 resigning and taking his large of book of business away from the firm, as argued by Firm X. Other than Principal 1's testimony, Firm X did not offer any evidence to support its allegation that Firm Y's Form U5 was false.

Principal 1 admits that he submitted variable annuity paperwork to product sponsor companies prior to receiving pre-approval from Firm Y, which was the basis for his termination. The fact that Firm Y sent the letter of caution to Principal 1 on May 25, 2010, then terminated him three months later for the same transgressions, does not, by itself, provide that Principal 1's Form U5 was false. Further, the letters sent by Firm Y to its customers of Principal 1 and Employee 1 after their separation from the firm explaining the risks associated with variable annuities and seeking acknowledgment that its customers' variable annuity investments were in their best interest by themselves also do not support Firm X's allegation. Indeed, we find the letters are consistent with Firm Y's obligations under FINRA supervision and suitability rules and were a reasonable response to Principal 1's admitted violations of firm policy.

c. The Evidence Does Not Support that Firm Y Updated Principal 1's Form U5 Prior to the Hearing

We likewise find there is no evidence to suggest that Firm Y updated Principal 1's Form U5 prior to the hearing. At the hearing, Firm X's counsel argued that additional evidence existed that showed that Firm Y updated Principal 1's Form U5. Pursuant to an order by the Subcommittee, Firm X filed a written motion after the hearing seeking to adduce an incomplete copy of a BrokerCheck report for Principal 1. We need not rule on the admissibility of the report because we take official notice of the document. *See, e.g., John J. Bravata*, Initial Decisions Release No. 737, 2015 SEC LEXIS 196, at \*8 n.4 (Jan. 16, 2015).

As an initial matter, we note that BrokerCheck derives the information available about brokers specifically from CRD. *See BrokerCheck Frequently Asked Questions*, available at <http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/P015174> (last visited Feb. 3, 2015). Principal 1's BrokerCheck report, when viewed in its entirety, reflects that, on August 26, 2010, Principal 1 experienced an "Employment Separation After Allegations"—specifically, that Firm Y "discharged" Principal 1 for the "Failure to follow firm policy regarding the pre-

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[cont'd]

Employee 1 was being 'retroactively' terminated for cause; and that if another Registered Representative who worked with me, Employee 2, did not resign that he would be terminated as well. Both Employee 2 and I submitted our resignations." Even if we were to conclude that Firm Y permitted Principal 1 to resign, we find he only did so after an investigation of a violation of his firm's policy regarding the pre-approval of variable annuities, and thus Firm X still does not meet the applicable standard. *See* NASD Rule 1014(a)(3)(D).

approval of variable annuities,” as described by both Principal 1 and Firm Y in the detail report. *See Richard Principal 1 BrokerCheck Report at 33, available at <http://brokercheck/finra.org> (last visited Jan. 27, 2015).* CRD likewise reflects that Firm Y discharged Principal 1 on August 26, 2010 for the “Failure to follow firm policy regarding the pre-approval of variable annuities.” Comparing BrokerCheck and CRD, we conclude that both sources undeniably reflect that Firm Y terminated Principal 1, and any difference in the language of the sources is immaterial.

## 2. Pending Arbitrations

NASD Rule 1014(a)(3) also instructs Member Regulation, when determining whether the standard has been met, to consider whether “an [a]pplicant’s or [a]ssociated [p]erson’s record reflects a sales practice event, a pending arbitration, or a pending private civil action.” NASD Rule 1014(a)(3)(B). In its decision letter, Member Regulation reasoned that the serious nature of the allegations required it to consider the pending arbitrations, particularly because Firm X proposed that Principal 1 would conduct the same business lines at Firm X without a supervisor. Member Regulation also found Firm X’s failure to disclose the first arbitration in its initial application to further evidence a “complete lack of regard for the regulatory rules designed to prevent and detect future violations of applicable regulatory provisions.” Firm X argues that the customer complaints that led to the arbitrations “are without merit, and were solicited against [Principal 1] by [Firm Y] as a personal attack.” Firm X also argues that Principal 1 “has continually disputed any direct involvement with the [complaining] clients.” Firm X therefore reasons that the pending complaints and arbitrations “are an insufficient basis for concluding that [Firm X] is unable to detect and prevent future violations of securities law such that he ‘cannot comply’ with the Standards of [NASD] Rule 1014(a).” We disagree.

The uncontroverted evidence provides that Principal 1 was a respondent in an arbitration at the time of Firm X’s initial application (which Firm X failed to disclose), and Principal 1 became the respondent in three additional arbitration matters during the pendency of the application. The allegations in the matters include false representations, fraud, negligent representations, failure to supervise, and unsuitable investments and recommendations. The fact the arbitrations have not been adjudicated does not mean the matters cannot or should not be considered by FINRA when reviewing an application for membership. To the contrary, NASD Rule 1014(a)(3) was amended in March 2004 to explicitly direct consideration of “pending arbitrations.” *Order Granting Approval of Proposed Rule Change, Exchange Act Release No. 48969, 2003 SEC LEXIS 3062, at \*4 (Dec. 22, 2003).* In affirming the rule change, the Commission stated it believed that the change was “appropriate because such matters may demonstrate an applicant’s ability or willingness to comply with the [Exchange Act], the regulations of the Commission and the rules of [FINRA].” *Id.* at \*8.

Firm X argues that Principal 1 did not have any direct involvement with the clients underlying the complaints and arbitrations. In his OTR, however, Principal 1 testified he was responsible for all aspects of the supervision of his branch’s three associated persons, including Employee 1. He further testified that his supervision responsibilities included approval of transactions, reviews of suitability, and reviews of communications. He said that although Employee 1 was permitted to recommend a variable annuity without discussing it with Principal 1, that did not occur. He also testified that he, his representative, and the client would get

together to discuss what variable annuity or REIT would be most appropriate for the client. Firm X did not reconcile these contradictions at the hearing.

Indeed, Firm X failed to offer evidence upon which we could conclude that the pending arbitrations should not be considered by us or Member Regulation or were solicited by Firm Y in retaliation for Principal 1 resigning from the firm. The letters that Firm Y sent to customers of Principal 1 and Employee 1 seeking their acknowledgment that their variable annuity investments were in their best interest do not by themselves evidence a retaliatory scheme by Firm Y. In fact, we find such letters are against the firm's own self-interest because they could expose not only Principal 1 to possible litigation, but the firm as well for a failure to supervise. At the hearing, Principal 1 testified that at least some of the investments that formed the basis of the complaints and arbitrations were profitable as of the hearing. Other than Principal 1's testimony and Firm X's description of the seven customer complaints submitted during the application process, Firm X offered no additional evidence regarding the underlying investments. For two complaints, Principal 1 testified he conducted "detailed research," and for the others a " cursory review." According to Principal 1, the customers "as of 2012, . . . they were up approximately around 20 to 30 percent in their annuities, they were down about five percent in their REITs, and as of May/June 2014, they were approximately one to five percent up in their REITs."

We find we do not have sufficient information to conclude that the investments underlying the complaints and arbitrations were, in fact, suitable. As an initial matter, we note that Principal 1 admits he conducted a mere cursory review of 21 of the 23 complaints. Moreover, for liability purposes with respect to suitability, the focus is on the suitability of broker's recommendations, not the end result. *See Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at \*37 (May 27, 2011) ("Suitability is determined at the time the recommendation is made; unsuitable recommendations do not become suitable if they later result in a profit."), *aff'd*, 693 F.3d 251 (1st Cir. 2012). Even if we were to find Principal 1's testimony credible about the profitability of the underlying investments, this testimony does not account for the other attributes of variable annuities that could make the investments unsuitable (e.g., liquidity issues, surrender charges, associated fees and expenses, tax considerations, etc.) for clients. *See FINRA Investor Alert; Variable Annuities: Beyond the Hard Sell* (June 2012), available at <http://www.finra.org/web/groups/investors/@inv/documents/investors/p125846.pdf> (last visited Jan. 27, 2015).

We conclude that Firm X, which bears the burden of demonstrating that it meets each of the standards of NASD Rule 1014, failed to offer evidence to substantiate its claim that the pending arbitrations should not be considered against Firm X with respect to whether it could meet the standard in NASD Rule 1014(a)(3).

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In conclusion, we find Principal 1 was terminated for cause and is named as a respondent in three pending arbitrations, and we find no reason to discount the implications of these events with respect to the standard articulated in NASD Rule 1014(a)(3). Based on Principal 1's termination for cause and the serious nature of the allegations against Principal 1 in the

numerous arbitrations, we conclude that Firm X failed to overcome the presumption of denial and failed to show that Principal 1, at this time, is capable of complying federal securities laws, the rules and regulations thereunder, and FINRA rules.

D. Firm X Failed to Demonstrate that It Satisfied the Standards of NASD Rule 1014(a)(9) and (10)

NASD Rule 1014(a)(9) requires Member Regulation to determine whether “[t]he Applicant has compliance, supervisory, operational and internal control practices and standards that are consistent with practices and standards regularly employed in the investment banking or securities business, taking into account the nature and scope of Applicant's proposed business.” NASD Rule 1014(a)(10) requires Member Regulation to determine whether “[t]he applicant has a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to prevent and detect, to the extent practicable, violations of the federal securities laws, the rules and regulations thereunder, and [FINRA] Rules.” Member Regulation found that Firm X failed to meet the standards based on Principal 1’s role in Firm X’s supervisory structure and Firm X’s proposed implementation of its WSPs. For the reasons explained below, we agree.

1. Principal 1’s Role in the Supervisory Structure

In its decision letter, Member Regulation found Firm X’s supervisory structure—in which Principal 1 would supervise himself on the same business lines that resulted in 23 customer complaints being filed against him—inadequate. Member Regulation noted that, while at Firm Y, Principal 1 was supervised, and Firm X was proposing that Principal 1 conduct the very same sales activities but with a less rigorous supervisory structure in which he supervised himself. Member Regulation also found that, at the membership interview, Principal 1 displayed a general lack of understanding and concern for several FINRA rules at issue in the application and was unable to articulate the basic components of a suitability review, how Firm X would ensure compliance with applicable rules relating to variable annuities and REITs, or how Firm X’s controls and processes would support an adequate supervisory system. Member Regulation further found Principal 1’s admission that he purposefully violated Firm Y’s pre-approval policies with respect to variable annuities to evidence indifference and blatant disregard for compliance responsibilities. Firm X argues that Member Regulation’s analysis ignores the fact that Firm X is relying on the limited size and resources exception under NASD Rule 3012. Firm X notes that the 23 customer complaints filed against Principal 1 “seem to be the primary motivation for Staff’s conclusion that a 30 year (sic) veteran of the industry with a near spotless record who is engaging an off-site FinOp and an independent compliance firm has a ‘disturbing lack of appreciation’ for the importance of an effective supervisory structure.” Firm X further argues that “the number of customer complaints being filed against Principal 1 has led to the tacit assumption that Principal 1 is at fault before the disputes are resolved.”

CRD reflects that Principal 1 was terminated for cause, is the subject of 23 customer complaints, and is the respondent in three pending arbitrations. The record shows that Firm X proposes that Principal 1 would serve as Firm X’s CEO, CCO, AMLCO, sole representative, producing manager, and only supervisor. Principal 2, who would be acting as an off-site FINOP,

would have no supervisory responsibility and has no experience selling variable annuities or REITs. The record further reflects Firm X's intent to employ Company Z, an outside compliance firm, to "perform a monthly on site (sic) inspection and write a report for regulatory review" and "assist [Firm X] in maintaining compliance." Firm X also notes, "FINRA will perform its Cycle Exam as well which will further ensure [Firm X] remains in compliance."

We agree with Member Regulation that Firm X has failed to demonstrate that its intended supervisory structure satisfies the standards of NASD Rule 1014(a)(9) and (10). First, Firm X's application of the limited size and resources exception is misguided. NASD Rule 3012(a)(2)(A)(i) laid out specific requirements for the written supervisory control procedures. It requires that a producing manager be reviewed and supervised by an "otherwise independent" person and that the review be alternated with another qualified person every two years. An "otherwise independent" person is defined as someone who does not report either directly or indirectly to the producing manager under review and who is located in a different office than the producing manager. In addition, the "otherwise independent" person must not have supervisory responsibility over the activity being reviewed, including not being directly compensated in whole or in part based on revenues accruing from the reviewed activities. NASD Rule 3012(a)(2)(A)(ii), otherwise known as the limited size and resources exception and upon which Firm X relies, provided: "If a member is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to [general supervisory requirements in NASD Rule 3012(a)(2)(A)(i)] . . . , the reviews may be conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures, provided that the reviews are in compliance with (i) to the extent practicable." NASD Rule 3012(a)(2)(A)(ii).<sup>20</sup> Thus, pursuant to the limited size and resources exception, small firms had an exception to the specific requirements of NASD Rule 3012(a)(2)(A)(i), not an exception from having requisite written supervisory control procedures, system, and infrastructure designed to ensure compliance with the applicable rules.

We, like Member Regulation, find that Firm X's intent to have Principal 1—who was terminated for cause, is the respondent in three pending arbitrations, and against whom 23 customer complaints were filed—function without supervision is a weak supervisory system which poses a risk to investors. Although Principal 1 has a 30-year career in the industry, his recent regulatory history raises serious questions about whether he is a sufficiently knowledgeable principal who may be relied upon to conduct supervision, including his own, at Firm X. Although the arbitrations are pending, the allegations contained therein are troubling and concern the same lines of business that Principal 1 would conduct at Firm X. Further, Principal 1 indicated that he would solicit customers similar to the complaining customers—i.e., retirees or those nearing retirement. The customer complaints also raise serious questions about Principal 1's ability to effectively supervise. We agree with Firm X that the 23 complaints filed against Principal 1 generally and almost identically contain the same allegations, but we note that we nonetheless would have the same concerns even if there were significantly fewer complaints.

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<sup>20</sup> NASD Rule 3012 was superseded by FINRA Rule 3120 on December 1, 2014. *FINRA Regulatory Notice 14-10*, 2014 FINRA LEXIS 17 (Mar. 2014).

“Customer complaints provide [FINRA] with important information that often times assists with the identification of problem firms, branch offices, and registered representatives.” *NASD Notice to Members*, 2000 NASD LEXIS 104, at \*57 (Sept. 2000). Indeed, reporting customer complaints “is intended to protect public investors by helping to identify potential sales practice violations in a timely manner.” *Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at \*44 (June 29, 2007). Member Regulation properly considered the customer complaints and their import with respect to investor protection when reviewing Firm X’s application for membership.

We disagree that Firm X’s engagement of Company Z presents “a supervisory structure that will effectively guard against future violations of federal securities laws, the rules and regulations thereunder, and [FINRA] Rules.” Firm X asserts that Company Z will “aid in meeting day to day compliance obligations,” “perform a monthly on site (sic) inspection,” “write a report for regulatory review,” and “will assist [Firm X] in maintaining compliance.” But as FINRA guidance emphasizes, “the ultimate responsibility for supervision lies with the member.” *NASD Notice to Members 05-48*, 2005 Notice to Members 48, at \*4 (July 2005). Company Z personnel are not associated persons, are not subject to FINRA rules, generally cannot be held liable for firm violations, and thus are an unacceptable substitute for proper supervision by the firm in this instance. Company Z personnel further cannot provide on location and continuous day-to-day and point-of-sale oversight to associated persons, which we find, at a minimum, necessary to supervise someone with Principal 1’s regulatory history at this time.

Firm X argues that, at the membership interview, it proposed to have an outside person supervise Principal 1, but Member Regulation declined because Principal 1, through Firm X, would be paying the supervisor and it would create a conflict of interest. Firm X also proposed to have an outside broker-dealer supervise Principal 1, but Member Regulation said that would also create a conflict of interest between Firm X and the other broker-dealer.<sup>21</sup> At the outset, we note that neither of these proposed alternatives was included in Firm X’s application, and we consider on appeal the application as it was presented to Member Regulation. We do not think that paying a representative to supervise a president and indirect owner of a firm with a regulatory history would necessarily create a conflict of interest or is otherwise untenable in certain circumstances. Firm X, however, did not offer a specific supervisor who would subject Principal 1 to heightened supervision or such a supervisory system for FINRA to consider. An outside broker-dealer supervising Principal 1, however, on its face, seems untenable because the supervisor would not be registered at Firm X and would not have the authority to enforce Firm X’s policies and procedures. *See id.* (“[A] member may never contract its supervisory and compliance activities away from its direct control.”).

In its decision letter, Member Regulation found that Principal 1 was unable to articulate the basic components of an adequate suitability review.<sup>22</sup> At the hearing, Principal 1 testified

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<sup>21</sup> At the hearing, Principal 1 also testified he would put himself under heightened supervision if there was a way to do it.

<sup>22</sup> Member Regulation staff testified to the same at the hearing.

generally how he qualified products and made recommendations to customers at Firm Y and how he would conduct a suitability review at Firm X. Firm X also introduced a suitability checklist for FINRA Rule 2111 that Principal 1 testified he would employ at Firm X. We need not find that Principal 1 is unable to articulate a basic suitability review to conclude that Firm X's supervisory system is inadequate.<sup>23</sup>

Firm X argues that Principal 1's termination for cause and 23 customer complaints were "crucial to [Member Regulation's] conclusion that [Firm X] failed to meet the standards set forth in Rule 1014(a)." We agree. Principal 1's recent regulatory history raises significant concerns, and therefore, a robust supervisory system at Firm X would be of the utmost importance. We find that Firm X's proposed supervisory practices, standards, and system, in which Principal 1 functions without supervision, and Firm X's reliance on Company Z to bolster its supervisory system, however, falls well short and does not adequately address those concerns and therefore poses a serious risk to investors.

## 2. Firm X's Implementation of Its WSPs

In its decision letter, Member Regulation also found Firm X's intent to not place Principal 1 under heightened supervision to be in contravention of Firm X's WSPs and sufficient reason by itself to deny the application because it evidenced a culture of non-compliance at Firm X. Firm X argues that, because Firm X intends to rely on the limited size and resources exemption of NASD Rule 3012, "[NASD Rule 3012] would prevail if inconsistent with [Firm X's] WSPs [and] [a]ny inconsistency is then reconcilable due to the fact that the WSPs are not designed to provide for every single contingency." Firm X continues that, "[t]he WSPs would simply have been amended to reflect the position that [Firm X] could in its judgment make a temporary exception for the enforcement of heightened supervision if it has a reasonable belief that the customer complaints are frivolous or retaliatory."

Firm X's business plan submitted with its application provides: "The Firm will further establish heightened supervisory procedures and special educational programs for any Associated Person whose records reflect: . . . (ii) customer complaints . . . . Further details concerning any heightened supervision requirements are contained in the Firm's [WSPs]." The first page of the WSPs notes that the procedures cannot address every situation and the appropriate person may exercise discretion when necessary. Section 2.1.2 of Firm X's WSPs provides that if any "associated person has been subject to three or more customer complaints and arbitrations in the previous five years . . . , the Firm will establish, maintain, and enforce

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<sup>23</sup> Of course, Principal 1's ability to articulate the basic components of an adequate suitability review has no bearing on our conclusion that Firm X failed to offer evidence to substantiate its claim that the pending arbitrations and complaints against Principal 1 should not be considered for purposes of FINRA's review of Firm X's application. We explicitly find that Firm X failed to put forth sufficient information to conclude that the investments underlying the arbitrations and complaints were, in fact, suitable.

heightened written procedures for supervising the activities of the associated persons.” Section 3.2.10 provides, “Heightened supervision is warranted whether the registered representative has a history of customer complaints, disciplinary actions, or arbitrations . . . .” In response to Member Regulation’s initial inquiry about how Firm X intended to comply with its own heightened supervision requirement in light of Principal 1’s regulatory history, Firm X stated, “Principal 1 will not be subjected to heightened supervision. [Firm X] employs Principal 1 as its sole representative.”

Firm X’s argument misses the mark. Firm X’s reliance on the limited size and resources exception does not permit Firm X to maintain a less robust supervisory system, procedures, and infrastructure. At the hearing, Principal 1 testified that whereas he would place another representative under heightened supervisions who had 23 customer complaints, pending arbitrations, and a termination for cause, Firm X’s WSPs are “situational dependent,” and his situation did not warrant heightened supervision because the complaints “were not coming from clients, but . . . individuals that wanted to make money off of my fairly large book of business.” We are troubled that Firm X intends to rely on Principal 1’s discretion as a means to not implement its WSPs with respect to his heightened supervision at Firm X. FINRA consistently has recommended heightened supervisory procedures for registered representatives with a history of *pending* customer complaints, disciplinary actions, or arbitrations. *See, e.g., NASD Notice to Members 97-19*, 1997 NASD LEXIS 23, at \*12 (Apr. 1997) (“While final disciplinary actions, complaints, or arbitrations resolved in a manner adverse to the registered representative indicate a disciplinary problem, multiple pending complaints, disciplinary actions, or arbitrations may be indicative of a history that should be carefully reviewed.”). Indeed, the Commission too has long emphasized the need for heightened supervision when a firm employs associated persons with known regulatory problems or customer complaints. *See Robert J. Prager*, 58 S.E.C. 634, 658-59 (2005). The WSPs, as drafted, also recognize the significance of an associated person being the subject of three or more customer complaints or arbitrations because the procedures require heightened supervision in such instances. The WSPs, as drafted, also do not explicitly provide for a subjective determination concerning heightened supervision by anyone, let alone the person who is the subject of the customer complaints, that the complaints are without merit.

Notwithstanding the guidance from FINRA and the Commission and Firm X’s apparent acknowledgement in its own WSPs of the significance of regulatory history, Firm X argues that Principal 1 should be excused from heightened supervision because he is the sole representative at Firm X and because Principal 1 believes the complaints against him are frivolous and retaliatory. Such a supervisory system poses the potential for abuse and incredible risk to the investing public. Firm X’s failure to appreciate the seriousness of Principal 1’s regulatory history, even if not yet adjudicated, and the potential risk to investors is disconcerting. We are further troubled by Principal 1’s testimony at the hearing that he would consider hiring someone at Firm X with similar regulatory history—specifically, Employee 1, whom he previously supervised at Firm Y and against whom numerous complaints and arbitrations were lodged for the very same transactions. Under Firm X’s proposed implementation of its WSPs, Employee 1 would be subject to heightened supervision by Principal 1. We could not consider ourselves stewards of investor protection if we were to allow such a supervisory structure to exist in the face of numerous pending arbitrations and customer complaints, particularly in light of the clear

directive from both FINRA and the Commission regarding customer complaints and heightened supervision.

Finally, Firm X attempts to distinguish *Asensio & Company, Inc.*, Exchange Act Release No. 68505, 2012 SEC LEXIS 3954 (Dec. 20, 2012), a denial of membership affirmed by the Commission and cited by Member Regulation in its decision letter. In that case, the applicant firm was denied membership where the sole principal, who was statutorily disqualified as the result of regulatory history, was proposing to serve in every executive and officer capacity of the firm. *See id.* Firm X argues that *Asensio* is not persuasive because the principal's disciplinary history was more severe and he was statutorily disqualified; the firm had no specific plan for heightened supervision whereas Firm X does; the firm was not relying on the limited size and resource exception; the firm was proposing the principal would serve in every capacity, including as the FINOP, whereas Firm X proposes to employ a FINOP; and the firm, unlike Firm X, did not employ an outside compliance firm.

We find Firm X's arguments unpersuasive. First, whereas Firm X's WSPs may provide for heightened supervision, by its own admission, it does not intend to implement them with respect to Principal 1. Second, to the extent that the applicant firm in *Asensio* was seeking to operate with only one principal, it was seeking to operate under an exception to FINRA's supervision rules. Regardless, as we have emphasized throughout this decision, Firm X's reliance on the limited size and resources exception does not allow it to operate without adequate written supervisory procedures and infrastructure. Third, Firm X's intended use of Principal 2 as an off-site FINOP is irrelevant to Firm X's supervisory structure: Principal 2 has no supervisory role and no experience with REITs and variable annuities. Fourth, although the statutory disqualification and corresponding disciplinary history of the firm's principal in *Asensio* is more severe than Principal 1's regulatory history, that comparison does not mean that Principal 1's history is not troubling for the reasons stated herein: established precedent and guidance provide for heightened supervision for associated persons with a history of pending customer complaints and arbitrations. Finally, as we explained, Firm X's intended use of an outside compliance firm is not a substitute for the requisite level of supervision at Firm X.

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Based on the foregoing, we agree with Member Regulation that Firm X does not have the supervisory practices, standards, and system designed to ensure compliance with federal securities laws, the rules and regulations thereunder, and FINRA rules. Indeed, we find that Firm X's proposed supervisory system is wholly inadequate based on Principal 1's termination for cause, pending arbitrations, and customer complaints. Further, Firm X's WSPs do not accurately reflect Firm X's intended implementation of heightened supervision at Firm X, and Firm X's intended implementation does not provide for heightened supervision of an associated person with a known history of customer complaints and pending arbitrations. Therefore, we find that Firm X failed to overcome the presumption of denial. Firm X failed to demonstrate it could meet the standards in NASD Rule 1014(a)(9) and (10) because Firm X's supervisory practices, standards, and system failed to adequately account for Principal 1's recent and relevant regulatory history to ensure compliance with federal securities laws, the rules and regulations thereunder, and FINRA rules.

IV. Conclusion

After a complete and independent review of the record, we conclude that Firm X failed to overcome the presumption of denial and failed to establish that it has satisfied all fourteen standards set forth in NASD Rule 1014(a). Accordingly, we affirm Member Regulation's denial of the application.

On behalf of the National Adjudicatory Council,

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Marcia E. Asquith,  
Senior Vice President and Corporate Secretary