

This Order has been published by the NASDR Office of Hearing Officers and should be cited as OHO Order 01-17 (C9A010011).

**NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS**

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| DEPARTMENT OF ENFORCEMENT, | : | |
| | : | |
| | : | |
| Complainant, | : | Disciplinary Proceeding |
| | : | No. C9A010011 |
| v. | : | |
| | : | Hearing Officer - DMF |
| | : | |
| | : | |
| | : | |
| Respondent | : | |

**HEARING PANEL ORDER GRANTING COMPLAINANT’S MOTION
FOR PARTIAL SUMMARY DISPOSITION**

Introduction

The Department of Enforcement filed a Complaint in this matter charging that respondent _____ violated NASD Rules 3040 and 2110 by participating in private securities transactions for compensation without giving written notice to and obtaining written permission from the NASD member firm with which he was associated, and violated Rules 2310 and 2110 by recommending unsuitable investments to customers. The parties filed cross motions for partial summary disposition with regard to _____’s liability under the first charge.

Pursuant to Rule 9264, a party may move for summary disposition of any or all of the causes of action in the complaint. The Hearing Panel may grant such a motion if there is no genuine issue with regard to any material fact and the party that files the motion is entitled to summary disposition as a matter of law. In this case, the parties agree that there is no dispute that _____ participated in the sale of certain notes for compensation

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without notifying his firm or obtaining the firm's permission; they disagree only on the legal issue whether the notes were "securities." There is no dispute that if the notes were securities, _____ violated Rules 3040 and 2110, but if the notes were not securities, he did not violate those rules.¹

For the reasons set forth below, the Hearing Panel finds that the notes in question were securities, and therefore grants Enforcement's motion and denies _____'s motion.

Discussion

The notes were issued by Redbank Petroleum, Inc. and Technical Support Services, Inc. ("TSS"). _____ sold notes with face values totaling more than \$240,000 to five customers, receiving a seven to nine percent commission on each sale.² Redbank and TSS subsequently defaulted on the notes.

The parties agree that whether the Redbank and TSS notes were securities turns on an application of the standards set forth in Reves v. Ernst & Young, 494 U.S. 56 (1990). In Reves, the Supreme Court established a "family resemblance" test to determine whether notes are securities. As a general rule, notes are securities, unless they either fall within a few generally recognized exceptions, or bear a strong resemblance to

¹ Rule 3040 prohibits a person associated with a member firm from participating in any manner in any private securities transaction (defined as a securities transaction outside the regular course or scope of the person's employment with the member) without giving prior written notice to the member and, if the associated person may receive selling compensation, receiving prior written approval from the member. In this case, there is no dispute that _____ participated in the sale of the notes outside the regular course of his employment; that he received compensation for doing so; and that he did not give notice to or obtain permission from his employer. Thus, if the notes were securities, _____ violated Rule 3040, and thereby violated Rule 2110.

² _____ sold a \$150,000 Redbank note to customer JK; a \$10,000 Redbank note to customer NS; a \$20,000 Redbank note to customer NW; and a \$25,000 TSS note and a \$35,403.94 TSS note to customers SB and RB.

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the excepted instruments. The exceptions include “the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a ‘character’ loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).” *Id.* at 65. Thus, the exceptions generally concern notes issued in consumer or commercial transactions, as distinguished from notes sold to members of the general public as investments.

The Supreme Court identified four factors to be considered in determining whether a note resembles the exceptions. The factors include: (1) the motivation of the seller and buyer of the note; (2) the plan of distribution of the note; (3) the reasonable expectation of the investing public; and (4) other factors that might reduce the risk to purchasers, such as an alternative scheme of regulation. No single factor is determinative. “Rather, a balancing of the four [factors] must be conducted in order to determine whether, on the whole, the note looks more like a security than not.” *In re NBW Commercial Paper Litigation*, 813 F. Supp. 7, 11 n.7 (D.D.C. 1992).

With regard to the first factor, a note is likely to be a security “[i]f the seller’s purpose is to raise money for the general use of a business enterprise ... and the buyer is interested primarily in the profit the note is expected to generate.” *Reves*, 494 U.S. at 66. In this case, Redbank stated that it planned to use the funds generated from the sale of the notes to “acquire existing oil properties and leases [and] to apply some of the newest technologies available in the oil and gas industry to these properties in order to extract the

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maximum amounts of resources.” CX J. TSS said it planned to use the funds it raised “to assist our rapid growth, and to specifically assist with the completion of standard training materials that can be sold to many companies.” CX L. Thus, in both cases the issuer’s purpose was to raise money for the general use of the business. Furthermore, during the investigation _____ testified that the customers who bought the notes did so in order to obtain a higher rate of return than they were receiving from their other investments.

_____ points to the words “loan” or “lend” in the issuers’ promotional materials, as if those words were somehow inconsistent with the notes being securities. Every note, however, reflects some sort of loan. As the Supreme Court explained in Reves, “Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made, and by whatever name they are called.” (Emphasis in original.) _____ himself admitted during his investigative testimony that his customers purchased the notes as investments. Therefore, the first Reves factor weighs in favor of treating these notes as securities.

The “plan of distribution” factor identified in Reves concerns whether the notes are “offered and sold to a broad segment of the public.” 494 U.S. at 68. In this case, no specific purchasers of the notes, other than _____’s customers, are identified in the record, but the promotional materials issued by Redbank and TSS suggest that the notes were offered to a broad segment of the public. Certainly _____’s customers were solicited as public investors.

_____ urges that the absence of a secondary market in the notes weighs against finding that they were securities. But while a secondary market is a strong indication that

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notes are securities, the reverse is not necessarily true. There are many cases holding that notes that were not, and perhaps could not have been traded were nevertheless securities, so long as they were sold to public investors as investments. See, e.g., Stoiber v. SEC, 161 F.3d 745, 750-51 (D.C. Cir. 1998). Here the manner in which the notes were marketed is entirely consistent with finding that they were securities. Therefore, this factor too weighs in favor of treating the notes as securities.

With regard to the reasonable expectations of investors, the materials issued by Redbank advised that “Promissory Notes are considered exempt securities, although they are subject to the scrutiny of securities law and anti-fraud provisions of the 1993 [sic] Securities Act.” CX J. Similarly, the materials issued by TSS stated “Promissory Notes are considered exempt from registration, although they are subject to the scrutiny of the Securities Law and the anti-fraud provisions of the 1933 Securities Act.” CX M. As stated in Reves, “it would be reasonable for a prospective purchaser to take the [issuer of the notes] at its word.” 494 U.S. at 70. Here, again, _____ simply points to the use of the words “loan” or “lend” in the promotional materials, but, as explained above, those words are by no means inconsistent with the issuers’ representations that the notes were subject to the protections of the securities laws. This factor weighs in favor of treating the notes as securities.

Finally, there is no indication that the notes were subject to any alternative scheme of regulation that would reduce the risk to investors, rendering application of the securities laws unnecessary. On the contrary, as noted above, the issuers of the notes specifically advised purchasers that the securities laws were the applicable scheme of protective regulation.

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_____ contends that there were other risk reducing factors applicable to these notes, including “many causes of action in the justice system,” representations by the sellers that the notes were insured, and the fact that the notes were represented as payable on demand. The availability of private causes of action, through which investors may attempt to recover losses, is no substitute for the protection against loss afforded by the securities laws. And while in some circumstances private insurance might reduce the risk to investors, there appears to be no dispute that in this case the alleged insurance was non-existent. Finally, in Reves the Supreme Court specifically rejected as “unpersuasive” a contention that “the demand nature of the notes is very uncharacteristic of a security.” 494 U.S. at 69.

Conclusion

The Hearing Panel finds that the Reves factors weigh overwhelmingly in favor of finding that the notes at issue in this case were securities. Therefore, in light of the undisputed facts, the Hearing Panel finds that _____ violated Rules 3040 and 2110, as alleged in the First Cause of Complaint. The remaining issues for the hearing are what sanctions should be imposed for this violation, as well as both liability and sanctions under the Second Cause of Complaint.

HEARING PANEL

By: David M. FitzGerald
Hearing Officer

Dated: Washington, DC
August 31, 2001