ADMINISTRATIVE PROCEEDING
FILE NO. 3-8312

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	)
Consolidated Investment Services, Inc.	)
Norman P. Rounds	)
James L. Fainter	)

INITIAL DECISION

Washington, D.C.
December 8, 1994

Glenn Robert Lawrence
Administrative Law Judge

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APPEARANCES: Amy J. Norwood and Robert M. Fusfeld of the Central Regional Office, for the Division of Enforcement.

Martin Berliner of Berliner, Zisser, Walter and Gallegos, for the Respondents Consolidated Investment Services, Inc., Norman P. Rounds and James L. Fainter.

BEFORE: Glenn Robert Lawrence, Administrative Law Judge.

These public proceedings were instituted by an order of the Commission dated March 8, 1994 (Order) issued pursuant to Sections 15(b)(4)(E), 15(b)(6)(A), 19(h) and 21B of the Securities Exchange Act of 1934 (Exchange Act) to determine whether allegations of misconduct made by the Division of Enforcement (Division) against the respondents, Consolidated Investment Services, Inc. (CIS), Norman P. Rounds (Rounds) and James L. Fainter (Fainter) are true and what, if any, remedial action is appropriate in the public interest.

In substance, the Division alleges that Rounds and Fainter, while principals of CIS, failed to supervise a registered representative named Theodore McCormick (McCormick) in violation of the securities laws. McCormick, who came to CIS with a disciplinary history in the securities industry, carried out a Ponzi scheme while associated with CIS which ultimately resulted in approximately $2.3 million of investor losses and McCormick's conviction of mail fraud and incarceration. Stipulation 6, Division of Enforcement's Proposed Findings of Fact and Conclusions of Law at 1 (hereinafter Stip.__ and DPFF at __). The Division contends that during McCormick's employment, Rounds, Fainter and CIS failed to reasonably supervise McCormick with a view toward preventing his violations, including a failure to adequately investigate McCormick's background before hiring him, and failure to establish and carry out adequate supervisory procedures and practices such as; surprise inspections, questioning of McCormick's clerical staff, contact with McCormick's CIS customers, review of correspondence, on-site supervision or any other procedures appropriate for a representative, especially one with a disciplinary history.

Respondents answered, admitting McCormick had worked for them for

approximately five years, and during that time had sold fraudulent high rate certificates of deposit that did not exist. Respondents affirmatively stated that adequate supervisory practices and procedures were in existence and were implemented at the time of McCormick's employment, but would not in any event have been effective in uncovering fraudulent conduct such as McCormick's. Further, Respondents asserted in their Answer no statute or regulation required them to subject McCormick's brokerage operation to surprise visits. Affirmative defenses were raised of: (i) failure to state a claim for which relief can be granted; (ii) lack of a cause of action for granting a remedial sanction; (iii) lack of knowing or intentional error or omission related to supervision; and (iv) McCormick's violations of the securities laws could not have been prevented by respondents.

A hearing was conducted in Denver, Colorado on July 5, 7 and 8, 1994, and at the Federal Prison Camp in Florence, Colorado on July 6, 1994. The hearing was conducted to resolve the issues raised by the Order and respondents' Answer. Timely filings of proposed findings of fact, conclusions of law and briefs in support thereof were filed by the parties.

The findings and conclusions of this decision are based upon the preponderance of the evidence as determined from the record and upon my observation of the various witnesses that testified at the hearing, as well as the argument and proposals of facts and law of the parties and the relevant statutes and regulations.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Failure to Supervise Generally

Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act provide in the relevant

part that the Commission may take action against any broker or dealer or associated person who "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the securities statutes, rules and regulations], another person who commits such a violation, if such other person is subject to his supervision." Violation of sections 15(b)(4)(E) and 15(b)(6)(A) is predicated on a violation of the federal securities laws by a person associated with the broker-dealer and under the supervisory jurisdiction of that broker-dealer's supervisory principals or staff. The elements of proof necessary in finding a violation are: (i) an underlying securities law violation; (ii) association (employment) of the registered representative or other person who committed the violation; (iii) supervisory jurisdiction over that person; and (iv) failure of the broker-dealer and/or supervisory personnel to reasonably supervise the person who violated the securities laws, with the standard of reasonableness being whether supervision was conducted with a view to preventing violations of the securities laws. The so-called "safe harbor" provisions of Exchange Act section 15(b)(4)(E) (and section 15(b)(6)(A) by reference) provide that a broker-dealer or associated person shall not be deemed to have failed reasonably to supervise if procedures and a system for applying those procedures have been established which "would reasonably be expected to prevent and detect, insofar as practicable any such violation" and the person as "reasonably discharged the duties and obligations incumbent upon him . . . without reasonable cause to believe that such procedures and system were not complied with." Exchange Act § 15(b)(4)(E)(i)-(ii).

The standard of reasonableness applicable to remedial actions for failure to supervise under section 15(b) of the Exchange Act is measured as "reasonable supervision under the attendant circumstances," Arthur James Huff, 48 SEC Docket 878,

883 (1991) (citing Louis R. Trujillo, 43 SEC Docket 690, 695). As the respondents correctly point out, "'what may be a reasonable discharge of supervisory duties in one case can be unreasonable in another . . . a factual analysis is required in each case.'" Respondents Brief in Support of Proposed Findings of Fact and Conclusions of Law at 22 (hereinafter Resp. Brief at __) (quoting Huff, 48 SEC Docket at 883). The factual analysis required to determine whether supervision was reasonable is by no means a res ipsa loquitur or strict liability situation, whereby the finding of an underlying violation requires a finding of failure to supervise, as the Congress in adopting these supervision provisions stated: "[Because of the provisions § 15(b)(4)(E)(i)-(ii) of the Exchange Act] a supervisory employee is . . . not an absolute guarantor of the conduct of those whom he has the power to supervise." S. Rep. No. 379, 88th Cong., 1st Sess. (1963).

Supervision is an essential function of the broker-dealer. The Commission has "made it clear that it is critical for investor protection that a broker establish and enforce effective procedures to supervise its employees." Donald T. Sheldon, 52 SEC Docket 3826, 3855 (1992). Establishment of policies and procedures alone is not sufficient to discharge supervisory responsibilities, however, as on-going monitoring and review is necessary to ensure that the established procedures which make up the supervisory program are effective in preventing and detecting violations.1/

A global supervision program applicable firm-wide for all individuals, without on-going efforts to ensure compliance, is unacceptable. Supervision must be

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1/ See, e.g. Gary E. Bryant, 54 SEC Docket 431, 441 (1993) ("the procedures must ensure that restrictions issued are not ignored by branch managers, registered representatives, or any other office personnel."); Thompson & McKinnon, 43 S.E.C. 785, 788 (1969) ("Although it was registrant's stated policy . . . it failed to establish an adequate system of internal control to insure compliance with such policy."); Sutro Brothers & Co., 41 S.E.C. 443, 464 (1963) ("registrant did not expand its supervisory procedures . . . to keep pace with the rapid expansion of its operations").

"extraordinary" when the broker-dealer is aware of an individual's past improprieties, Sheldon, 52 SEC Docket at 3861,2/ and reasonable supervisory practices should vary with size and structure of the broker-dealer operations.3/

Against this backdrop of decisions dealing with broker-dealer supervision, this decision will examine the relationship of McCormick and CIS, Rounds and Fainter, concluding that respondents' failed to reasonably supervise McCormick and that sanctions are warranted.

2/ Respondents argue that Sheldon can be distinguished from the instant case because Sheldon, a president of a broker-dealer, had specific knowledge of the underlying fraud and other wrongdoing and the person to whom Sheldon had delegated supervisory responsibility died. While Sheldon admittedly differs from this case by virtue of the somewhat differing facts and circumstances, the point for which the case is cited in this decision and by the Division is that when a supervisor has notice of irregularities in conduct by a representative, whether through a series of red-flags or direct knowledge, "extraordinary" supervision and "utmost vigilance" are required of the of the supervisor. See also Michael E. Tennenbaum, 47 S.E.C. 703, 712 (1982) ("those in authority must exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention.").

3/ See Wedbush Securities, Inc., 48 S.E.C. 963, 967 (1988) ("in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise particular vigilance whenever even a remote indication of irregularity reaches their attention."). See also Universal Heritage Investments Corporation, 47 S.E.C. 839, 845 (1982); Michael E. Tennenbaum, 47 S.E.C. 703, 712 (1982). Concerns about broker-dealer supervision, particularly at organizations lacking close contact with representatives, as in the instant case, predate the passage of the 1964 amendments which established direct liability under Exchange Act §§ 15(b)(4)(E) and (6)(A). See Reynolds & Co., 39 S.E.C. 902, 916 (1960); R.H. Johnson & Co., 36 S.E.C. 467, 486 (1955), aff'd, 231 F.2d 523, cert denied, 352 U.S. 844 (1956); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 391 (1945); Kidder Peabody & Co., 18 S.E.C. 559, 573 (1945); Bond & Goodwind, Inc., 15 S.E.C. 584, 601 (1944) ("Where a broker-dealer firm has a substantial number of employees, where considerable authority is delegated and where subordinates have power to exercise wide discretion, the protection of investors can obviously not be achieved if the firm is permitted to shield itself from the consequences of a subordinate's undetected violations by pleading the very conditions which made the violations possible. . . .").

CIS and the Hiring of Theodore McCormick

Consolidated Investment Services, Inc. (CIS) was originally formed as partnership in 1979 under another name and then incorporated in 1980 as CIS, with ownership consisting of respondents Rounds and Fainter and a third individual. Transcript (hereinafter Tr. __), pages 25-26. The firm registered with the Securities and Exchange Commission (Commission) as a broker-dealer under section 15(b) of the Exchange Act in 1981, and has remained registered as a broker-dealer since that time. Order Instituting Proceedings (hereinafter OIP), page 1; Answer, paragraph 1. Respondent Rounds has been president of CIS since its incorporation, and presently owns 95% of the corporation through a holding company named Cavalier Group. Tr. 27-28. Respondent Fainter, who now has a 5% stake in CIS, sold his 45% interest in CIS to Rounds in December 1989 and subsequently moved from Colorado to Bellevue, Washington in 1991. Tr. 27, 143. While the scope of CIS operations apparently varied over time, Mr. Rounds estimated that in 1987 the firm employed 100 to 125 registered representatives, with notably 50 to 75 operating out of "one-person offices." By early 1992, CIS employed approximately 300 registered representatives, with 25 to 30 "one-person office" operations. Tr. 38-39. At the headquarters office in Littleton, Colorado, where Rounds and Fainter carried out management of CIS, the firm employed clerical staff and three to six professionals during the period 1987 to 1992. Tr. 146. CIS was and is primarily engaged in the sale of partnership interests, mutual funds, annuities and some exchange-traded stocks and bonds. Tr. 151-52.

Some time prior to May, 1987 Fainter met McCormick at a conference in Monte Carlo sponsored by an issuer of securities which CIS sold. Tr. 154, 279. Fainter hired McCormick in May 1987 largely because he was present at this conference of "big

producers." Tr. 154. McCormick came to Colorado for a brief meeting with Rounds and Fainter prior to being hired, partly as an interview and partly to see the headquarters and meet prospective CIS supervisors and staff. Tr. 180, 281.

A Registered Representative Agreement was executed by McCormick with CIS when he was hired by the firm. Division Exhibit 41 (hereinafter D. Ex. __). The agreement established McCormick's relationship with CIS as an "independent contractor," and prohibited such conduct as: (i) acting on behalf of CIS except as provided in the agreement; (ii) accepting checks "in payment for securities payable to himself or anyone other than CIS, the issuer . . . or person designated by the issuer;" and (iii) without prior written approval operate discretionary accounts, or act as a custodian, or act for customers or accept remuneration in any securities transactions not in the capacity of a CIS representative, use CIS in advertising or other papers, underwrite securities or "sell or solicit the sale of any product which might be considered a security other than through CIS and as a representative of CIS."4/

McCormick's operated his CIS-related business out of a small office in El Paso, Texas. During most of his nearly five year affiliation with CIS, McCormick contends that he also operated a factoring company called Paradyne out of adjoining office space. Tr. 333. He apparently operated the securities business office under the name Ted McCormick Agency. Id. His Ted McCormick Agency operation during the period 1987-1992 employed two clerical assistants who answered phones, typed and filed for

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4/ The agreement also required the representative to submit all written communications between the representative and customers for review and approval by the branch manager. In addition, the agreement set out the representative's obligation to comply with securities laws and regulations, as well as the compensation arrangement between representative and CIS. D. Ex. 41. Similar agreements were executed in each year of McCormick's employment with CIS. D. Exs. 42 - 46.

McCormick. Tr. 335.

McCormick's El Paso office was not registered with the NASD as a branch office of CIS during his employment by the firm; rather, Rounds and Fainter stated he operated what the NASD terms a "non-branch business location." Tr. 61, 159. As a "non-branch business location," Rounds stated at the hearing that McCormick's office was affiliated for supervisory and other purposes with the "branch office" that was in fact CIS headquarters in Littleton, Colorado. Tr. 61. Respondents conceded in their post-hearing brief, however, that McCormick's office was in fact a branch office under the terms of NASD definitions promulgated in April, 1989, which meant that McCormick's "branch office" should have been inspected under Article III, § 27 of the NASD Rules of Fair Practice.5/ Resp. Brief at 17-18; Division's Brief in Support of Proposed Findings of Fact and Conclusions of Law at 21 (hereinafter Div. Brief at __).

McCormick was terminated by CIS in March, 1992 for the stated reason that he opened a margin account without authority from CIS. Tr. 131, D. Ex. 64. The testimony is that the Ponzi scheme McCormick operated while working at CIS was not discovered until November, 1992, after one of McCormick's defrauded investors contacted Rounds at CIS about Agency CD notes purchased from McCormick. Tr. 700.

5/ In order to qualify as a non-branch business location the NASD rules promulgated in April 1989, the representative may only identify himself to the public by (1) having a line listing in the telephone directory which also lists the address and telephone number of the office that supervises him; and (2) his letterhead and business card must include his supervising office's address and telephone number. Division's Proposed Findings of Fact and Conclusions of Law (DPFF) page 20, citing Tr. 211-213. If these conditions are not met, the representative is operating as a branch office. According to Division's Exhibit 60, an "Office of Supervisory Jurisdiction" is defined as "'any office designated as directly responsible for review of the activities of a registered representative . . . .'" D. Ex. 60, citing Article III, Section 27 of the NASD Rules of Fair Practice.

McCormick's Ponzi Scheme Violated Federal Securities Laws

From the very outset of his employment with CIS in 1987 until his termination in 1992, McCormick engaged in a Ponzi scheme, whereby he defrauded people by purportedly selling non-existent securities he fictionally titled Agency Certificate of Deposit Notes (hereinafter Agency CDs). Stips. 1 and 6, DPFF at 1. According to McCormick, in 1987 he placed 100% of his clients' money in legitimate investments while a registered representative with CIS. By 1992, McCormick recalls he was placing only 5% of clients' funds in legitimate investments and the remainder in the Ponzi scheme.6/ Tr. 400. McCormick endorsed the checks given to him by defrauded persons during the course of the Ponzi scheme, and no funds collected from the purported sale of the Agency CDs and other non-existent investments were transmitted to CIS. Stips. 3 and 4, DPFF at 1. None of McCormick's defrauded investors questioned CIS personnel about McCormick's Ponzi scheme investments before November, 1992, due largely to McCormick's deceptive skill and activities. Tr. 409-16, 696, 729.

McCormick routinely represented to investors that the Agency CDs were interests in a large denomination "master" bank certificates of deposit bought at wholesale rates, thus enabling him to offer higher rates than other retail CDs. Tr. 321-322, 324. He solicited investors from his existing client pool, as well as through investment seminars and newspaper advertisements. Tr. 318, 320, D. Ex. 27. As part of his scheme, as indicated, McCormick used his business card (D. Ex. 28), an altered CIS brochure

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6/ McCormick contradicted his testimony regarding placement of his clients' funds in 1987 when he stated that he sold Chester Hammonds one of his illegitimate "Agency CD Notes" in late 1986 while at Caprock Securities, and misappropriated $13,000 of Molly Thomas' funds for his own use in 1987 without selling her an "Agency CD Note." Tr. 268-71.

listing Agency CDs as a CIS product and listing only McCormick's El Paso address (D. Ex. 1), and a Securities Investor Protection Corporation (SIPC) brochure (D. Ex. 2). McCormick's business card, which bore the CIS logo and only McCormick's El Paso address and telephone number, misrepresented McCormick as a Division Manager (his former title at Waddell & Reed) along with the fictional designations McCormick created of F.P. (''Financial Planner'') and C.A. (''Certified and Accredited''). Tr. 474-75. The CIS brochure, where the phrase ''Agency CDs'' was obviously added to the bottom of the list of legitimate CIS investments and bore only McCormick's El Paso address, was modified by McCormick. Tr. 459. McCormick used the SIPC brochure when representing to investors that their Agency CDs were fully insured by the Securities Investor Protection Corporation. Tr. 581-82.

Several bogus documents were prepared by McCormick at his El Paso office for the furtherance of the Ponzi scheme. One type of document represented the "notes" memorializing the ''Agency CD Note'' investments. See, e.g. D. Ex. 16. Some investors received Receipts of Order (trade confirmations), bearing the CIS logo, for their Agency CDs. See, e.g. Respondent's Exhibit 35 (hereinafter R. Ex. __). Investors in the Agency CD Notes received quarterly statements from McCormick, detailing the interest accruing on the notes, amounts reinvested, and outstanding principal balances. See, e.g. D. Ex. 17. McCormick kept detailed records of the Ponzi scheme contributions and payments, first in handwritten form (R. Ex. 14) and later with computerized lists (R. Ex. 13, Tr. 360). According to McCormick, copies of all of these documents were kept at his El Paso location, generally within the filing cabinets, drawers or his briefcase located in his personal office. Tr. 342-44.

McCormick collected $5 million, some of which was paid as interest and

redemptions, from 50 to 60 persons during the course of his scheme, with nearly half constituting investors' retirement funds and some representing the entire life savings of individual investors. Tr. 265-68. McCormick entered into a plea agreement with the United States, pleading guilty to one count of mail fraud under 18 U.S.C. § 1341. R. Ex. 52. McCormick was also permanently enjoined by the United States District Court for the Western District of Texas from engaging in fraudulent activities in the sale of securities, based on his Ponzi scheme activities. D. Ex. 48

The parties stipulated that McCormick conducted a Ponzi scheme, selling Agency CD notes which did not exist and thereby defrauding investors of over $2 million. Stip. 1, 2, 6, DPFF at 1. The Division and respondents agree that McCormick violated Sections 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder (hereinafter referred to as "antifraud provisions"). RPFF at 6; DPFF at 40.

McCormick's activity was clearly a violation of the federal antifraud provisions. Investors were misled as to material information such as the use of the funds invested and the actual existence of the CDs in the offer and sale of the securities.7/ Applying the time-honored test enunciated in SEC v. W.J. Howey, 328 U.S. 293 (1946), the

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7/ Non-existence of an instrument does not logically preclude it from being defined as a security, particularly under the antifraud provisions:

> The antifraud provisions of section 10(b) and 10b-5 have been held applicable even in situations when a broker-dealer purported to sell nonexistent securities or securities that were to be issued in the future. See Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1040 (7th Cir. 1979); Seeman v. United States, 90 F.2d 88, 89 (5th Cir. 1937). "The fraud provisions are not defeated by the fact a security purportedly traded is nonexistent or fictitious. . . . A contrary result would encourage rather than curb fraud." 1 A. Bromberg, Securities Law: Fraud-SEC Rule 10b-5, § 4.6 at 316 (1977).

First Nat'l Bank, et. al. v. Estate of Russell, 657 F.2d 668, 673 n.16. (5th Cir. 1981).

Agency CD notes and similar instruments created by McCormick fall within the statutory definition of a security as investment contracts.8/ McCormick's fraudulent intent9/ is clearly established in the record. His devious scheme involved the use of bogus documents discussed above, including false sales brochures, false statements of interest, false note agreements and false trade confirmations. McCormick deposited investor funds in his own account for largely his personal use, and paid "interest" to his investors from those funds so they would think they were participating in legitimate investments. McCormick's grandiose misrepresentations to investors regarding his prowess at securing superior returns and his substantial efforts to reassure skittish investors such as Mr. Montez were express manifestations of McCormick's scienter while perpetrating the scheme. D. Ex. 23-26.

For the foregoing reasons, the Ponzi scheme perpetrated by McCormick violated the antifraud provisions of the federal securities laws. McCormick, acting with fraudulent intent, offered and sold securities based on material misrepresentations and schemes and artifices meant to defraud.

8/ The Howey test finds an investment contract when there is: (i) an investment of money; (ii) in a common enterprise and (iii) with an expectation of profits derived solely from the efforts of others. All of these conditions are satisfied by the Agency CD notes, because defrauded investors invested money, with sufficient pooling of funds and pro rata profits to establish horizontal commonality, hoping to receive profits based on McCormick's efforts to secure large denomination CDs.

9/ Fraudulent intent (scienter) is required to establish a violation of the antifraud provisions, Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10-b thereunder. Aaron v. SEC, 446 U.S. 680, 697 (1980). Scienter has been defined as a "mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976).

CIS Supervision of McCormick

The record in this case lacks any written confirmation of who, if anyone, was charged with supervising McCormick while he was employed by CIS. Tr. 148. McCormick claims he was never told who his immediate supervisor was during the time he worked for CIS. Tr. 289. Kuijper, the compliance officer during most of McCormick's employment, did not know whether Rounds or Fainter were McCormick's immediate supervisor. Tr. 517. It is therefore necessary to determine who was responsible for McCormick's supervision from the testimony of the parties, the listed duties of Rounds and Fainter and all the circumstances related to McCormick's employment.

Fainter's supervisory responsibilities for McCormick are evident from his own admissions (Tr. 145, 721) and his extensive contacts such as: hiring McCormick (Tr. 154); performing an informal review of McCormick's employment history (Tr. 163-66, 716); reviewing his transactions (Tr. 53, 180-81, 184); and visiting McCormick's El Paso office on an informal basis one occasion (Tr. 167-72, 722). Further, Fainter's listed duties and responsibilities as senior vice president included supervising office managers and developing and implementing programs for the evaluation of compliance by registered representatives (D. Ex. 35, p. 6).

Respondents point out that there is no dispute that Fainter served as McCormick's supervisor until at least November 1989 when he sold 45% of his CIS interest to Rounds. Resp. Brief at 14; see Tr. 145. It is apparent Fainter's CIS management responsibilities, including supervision of registered representatives, were significantly curtailed after he sold all but 5% of his interest in CIS to Rounds in December 1989. Tr. 148, 721. Fainter eventually moved to Bellevue, Washington in November, 1991

and took lesser responsibility for day-to-day CIS operations, and the number of registered representatives he supervised decreased substantially. Tr. 32, 143, 149, 721. Fainter, admitting he was McCormick's supervisor at the outset of their relationship, stated he was not sure whether he ceased being McCormick's immediate supervisor prior to when he moved to Bellevue in 1991.10/ Tr. 145.

Rounds assumed or should have assumed supervisory responsibilities with respect to McCormick, at least beginning with Fainter's sale of most of his interest in CIS in December, 1989. Even before December, 1989, McCormick corresponded and communicated with Rounds exclusively on matters including sanctions imposed by the NASD (D. Ex. 34), proposed communications with investors (D. Ex. 33), adding a registered representative to the office (D. Ex. 65, Tr. 102), and proposed outside business ventures (Tr. 99-101, 691-92). Rounds, acting during McCormick's employment as the president of CIS, had "no idea" why McCormick came to him regarding supervisory matters such as adding a registered representative to the El Paso office. Tr. 103. Rounds finally fired McCormick without consulting Fainter in March 1992, when Rounds detected McCormick's impermissible margin account activity. Tr. 736, D. Ex. 64. As president of CIS, Rounds held "ultimate responsibility for every phase of CIS operations." D. Ex. 37, p. 7a. The Division argues persuasively, in substance, that Rounds necessarily had supervisory responsibilities for McCormick due to his ineffective delegation as president of the firm of supervisory duties to Fainter and Kuijper. Div. Brief at 12-14. The Commission has indicated on many occasions that:

10/ On later direct examination by his own counsel, Fainter affirmatively stated that he was McCormick's supervisor up until the buy-out transaction between he and Rounds in December, 1989. At this time CIS did not amend the form designating McCormick's supervisor filed with the NASD. Tr. 721.

> The president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient.

Thomas F. White, 57 SEC Docket 486, 489 (1994).11/ Rounds admitted he did not determine whether Fainter properly carried out his supervisory responsibilities for McCormick (Tr. 42-43), and did not know what steps Fainter took in supervising McCormick (Tr. 117).12/ The intimate nature of the management relationships at the CIS offices (as contrasted with larger broker-dealers) put Rounds in daily close contact with persons to whom he delegated supervisory responsibility, and the problems created by the representatives supervised.13/ Such close contacts between all of the principals cannot support the "Chinese wall" concerning supervision of McCormick that Rounds has attempted to establish in his testimony.

The Division correctly asserts that Rounds had reason to know his delegation of supervisory authority would become ineffective upon the reduction in Fainter's ownership interest in December, 1989. Div. Brief at 13. When Fainter reduced his equity interest in the corporation, he apparently abdicated many his responsibilities in the conduct of CIS operations. At this time, Rounds knew or should have known Fainter's supervision of McCormick and other registered representatives would decrease, and he made no

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11/ Quoting Smartwood, Hesse, Inc., 52 SEC Docket 2219, 2229 (1992); See also Donald T. Sheldon, 52 SEC Docket 3826, 3855 (1992); Universal Heritage Corp., 47 S.E.C. 839, 845 (1982).

12/ Rounds stated at the hearing that he did not review the performance of persons charged with supervisory responsibilities and had no reason to believe Kuijper's performance was deficient. Tr. 704-5. Kuijper was not delegated supervisory jurisdiction over McCormick, rather he served as compliance officer.

13/ Rounds and Fainter discussed all important matters during the time they were equal shareholders of CIS. Tr. 145. Rounds, Fainter and Kuijper "were constantly talking about supervisory matters at all times." Tr. 732. Their "offices were close to each other, [they] were in constant communication." Id.

effort to delegate supervisory responsibilities for McCormick to another CIS principal. The only possible person to whom Fainter's supervisor duties would have been Kuijper, who left CIS in 1991. Kuijper served as compliance officer, and did not have supervision of registered representative within his job description. D. Ex. 35, 10th page. Rounds testified in prior sworn testimony, which he contradicted at the hearing, that he was McCormick's immediate supervisor at least since Fainter moved to Bellevue in 1991 and possibly since Fainter sold most of his equity positions in December 1989. Tr. 71, 74. In the absence of evidence of a re-delegation of supervisory duties for McCormick in December 1989 and considering the affirmative statements made in prior testimony, Rounds, as president of CIS, assumed some or all of the direct supervisory responsibility for McCormick in December 1989. His delegation to Fainter lapsed, because it became unreasonable and ineffective when Fainter sold most of his interest in CIS and thereafter began supervising far fewer registered representatives and was "basically out of the loop of the day-to-day management activities of the firm" (Tr. 721). Rounds knew at the time of the buy-out that he and Fainter no longer shared responsibility for the operations of the company. Tr. 52, 75.

Rounds, Fainter and CIS, as McCormick's supervisors, were required under Exchange Act sections 15(b)(4)(E) and 15(b)(6)(A) to not only establish a supervisory and compliance system which reasonably can detect irregularities, but also to follow-up on those irregularities as "red flags" indicative of problems to come. As the Commission has stated:

> Red flags and suggestions of irregularities demand inquiry as well as adequate follow up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of federal securities laws.

Edwin Kantor, 54 SEC Docket 293, 301 (1993). Detection of "red flags" is predicated on a reasonable effort to supervise, and is necessary to ensure protection of investors. Numerous red flags were evident in this case before and during McCormick's affiliation with CIS and were ignored, went undetected or failed to cause reasonable concern at the firm.

In May, 1987 McCormick filled out for CIS a National Association of Securities Dealers (NASD) Form U-4, Uniform Application for Securities Industry Registration or Transfer. D. Ex. 30. In answer to Question H on page 2 of the Form, McCormick answered "yes" to a question asking if he had been subject to "an investment related . . . complaint or proceeding that (1) alleged compensatory damages of $10,000 or more, fraud or wrongful taking of property." Further, McCormick answered "yes" to Question N1, which asked if he had been permitted to resign or discharged because of a violation of investment statutes, regulations or standards of conduct. D. Ex. 30, 2nd page. In elaborating on these answers, McCormick attached an NASD complaint alleging (i) his conversion to his own use of a $10,000 check from a customer, payable to the broker-dealer Waddell & Reed and (ii) an incident where McCormick provided customers with a $117,000 check drawn on insufficient funds. In another attached form, McCormick indicated the firm of Waddell & Reed allowed him to resign. D. Ex. 30, pages 5-9. Fainter signed the U-4, indicating his review of the form and resulting knowledge of McCormick's disciplinary past. At the time of the filing of the Form U-4, Fainter had been effectively delegated supervisory responsibility for McCormick. Fainter did not call Waddell & Reed regarding McCormick's regulatory history. Tr. 165. Fainter hired McCormick on behalf of CIS despite the regulatory problems listed on the Form U-4 because "[t]here was nothing in his background that even remotely

suggested that he would end up doing what he eventually did several years later." Tr. 720. There is no evidence of enhanced supervision by Fainter or others on account of these red flags about McCormick's regulatory history.

Rounds claims he never saw the Form U-4 and did not know of McCormick's disciplinary history before McCormick's termination. Tr. 79, 82, 677. The record indicates Rounds, however, was given ample notice of McCormick's regulatory problems during the period 1987-1992. The NASD sent a letter to CIS for Rounds's attention about McCormick's disciplinary problems and the payment of a $5,000 fine in June 1988, to "assist [CIS] in properly carrying out its supervisory responsibilities." D. Ex. 31. A letter was sent from the NASD to CIS's Littleton office requesting payment of McCormick's $5,000 fine. D. Ex. 32. McCormick communicated with CIS (and in particular Rounds) about the NASD actions against him while he was employed by the firm. D. Ex. 34. Rounds spoke with McCormick about NASD disciplinary matters in 1991, and advised McCormick the CIS legal defense fund would not help him under the circumstances. Tr. 306-8. Rounds's failure to recall seeing these documents (Tr. 693-95) suggests either his complete lack of concern about supervising representatives or his lack of credibility. Again, supervisory controls on McCormick's activity were not increased by either Rounds or Fainter because of these red flags.

Respondents argue that the Division has mis-characterized the seriousness of McCormick's disciplinary background, given the relatively exculpatory language of the NASD District Business Conduct Committee (DBCC) No. 6 decision in the matters McCormick listed on his Form U-4. Resp. Brief at 21-22, referring to D. Ex. 49. On the first count, the decision concluded that no "sinister motive" could be attributed to McCormick's deposit of the $10,000 customer check in his account, though the conduct

was nevertheless in violation of NASD rules. (D. Ex. 49 at 4). On finding a violation of NASD rules for the second count, the DBCC nonetheless concurred with McCormick's characterization of tendering a $117,000 check drawn on nonsufficient funds to assuage concerned clients as "testimony to sheer stupidity." D. Ex. 49 at 5. In justifying a sanction of $5,000 the NASD was satisfied that the conduct "represent[ed] poor judgement and carelessness." D. Ex. 49 at 6. Respondents' argument that this decision somehow reduced their obligation to impose stricter supervision on McCormick is not in the least compelling. First, the decision was issued one year after McCormick was hired. In the interim between McCormick's disclosure of these complaints and the disposition of the case by the DBCC, the respondents knew from McCormick's Form U-4 filing that he had some recent problems with handling client funds. As CIS compliance officer Kuijper stated, a regulatory action against a registered representative would stand out to a broker dealer. Tr. 502. Respondents did not need the DBCC decision to determine whether McCormick had deceitful intent when he mishandled funds in order to structure a supervisory program for him. The complaints against McCormick were red flags, suggestions of irregularities--they need not rise to the level of dispositive findings. Second, even presuming respondents read the decision at the time of McCormick's employ,14/ the decision would have put them on notice that McCormick was a registered representative who exhibited "sheer stupidity," poor judgement and

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14/ There is no testimonial or documentary evidence the June 10, 1988 DBCC decision (D. Ex. 49) was in the possession of or read by the respondents at the time of McCormick's employment. Division Exhibit 31, the June 10, 1988 letter from the NASD to Rounds and CIS concerning the $5,000 fine did not include a copy of the decision as an attachment and indicated a copy of the decision would be available upon request. Further, if Rounds is to be believed on his other testimony regarding his practices with respect to Division Exhibit 31 and other documents, he would have been unlikely to read the DBCC decision even if it had been mailed to him. Tr. 693-95.

carelessness when handling client funds. Such notice could only contribute to concerns of a reasonable supervisor about a registered representative operating from a distant office with no direct oversight.

Respondents further point out that the NASD did not delay approval of the transfer of McCormick's registration from Waddell & Reed to Caprock and from Caprock to CIS, despite the pending complaints listed in the Form U-4. Resp. Brief at 2; RPFF at 2, citing Tr. 440, 535. The lack of NASD delay does not excuse the respondents from establishing and implementing an appropriate supervisory program for McCormick.15/

When McCormick first came to work as a registered representative with CIS, Fainter anticipated he would be a "big producer," but his "production" rapidly declined from 1987 to 1992. According to an April, 1994 intra-office memorandum to Rounds, McCormick generated the following net commissions with CIS:

Year	Net Commissions
1987	$31,534.11
1988	54,911.27
1989	17,859.43
1990	19,331.79
1991	4,803.72
1992	148.86

D. Ex. 72. There is no evidence that CIS personnel questioned the precipitous decline in McCormick's production numbers, even though he was obligated to not "sell-away."16/ Fainter and Rounds pointed out that they were aware McCormick engaged

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15/ See Application of Frank J. Custable, Jr., 55 SEC Docket 2068, 2075 n.14 ("The NASD's permission [for a representative to associate with the broker dealer] did not relieve the firm or [the supervisor] of their responsibilities").

16/ The term "selling away" refers to when a registered representative sells an investment product not authorized by the broker-dealer firm with which he is registered. Tr. 208, (continued...)

in a life insurance business, which may have accounted for the drop-off in commissions. Tr. 185, 685. Rounds discussed with McCormick his wish in 1989-90 to scale down his securities business while trying to start a business called Clock & Plaques. Tr. 99, 691-92. Neither Rounds nor Fainter attempted to verify or evaluate McCormick's assertions or their understanding of his situation, despite their pecuniary interest in him maintaining his securities business. No steps were taken in connection with this red flag, which suggested at the time McCormick may have been "selling away."

Both Fainter and Kuijper could not recall reviewing McCormick's business card, which included the "Division Manager" title and fictional "F.P." and "C.A." designations discussed supra. Tr. 162, 518. Fainter could not recall seeing McCormick's letterhead either.17/ Tr. 161. Rounds was aware McCormick was using business cards and letterhead which did not conform with firm policy, since it did not include the address of CIS headquarters. Tr. 97. Rounds provided no evidence that either he or Fainter took steps to correct the policy breaches and he was not sure whether Kuijper took any corrective action regarding these items. Tr. 97. As late as July, 1991 McCormick sent correspondence to Rounds on CIS letterhead bearing only

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16/(...continued)
D. Ex. 59, page 3. McCormick was prohibited from selling away by the terms of his registered representative agreement. Div. Exs. 41-42, 44-46. The Division points out that there is case law in the context of private controlling person liability cases under Exchange Act Section 20(a) which limits the liability of broker-dealer firms. Div. Brief at 25. The instant case is an administrative action brought under section 15(b)(4)(E) of the Exchange Act, which, as stated, clearly necessitates the imposition of sanctions if a broker-dealer fails to supervise and employ who commits a violation of the securities laws. Where the selling away involves a fraudulent scheme which violates the antifraud provisions of the securities laws, as in this case, it is impossible to conceive how the supervisory responsibilities imposed by section 15(b) are somehow limited.

17/ The use of this stationary without a home office address facilitated McCormick's fraud, in as much as his customers did not have the information to contact CIS and thereby verify the validity/legality of the transactions.

McCormick's El Paso address. D. Ex. 34. Adequate steps were not taken with respect to these indications of irregularity which would clearly facilitate McCormick's receipt and transmittal of customer funds and thereby "selling away" without the knowledge of CIS.

While employed by CIS, McCormick filed assumed name certificates in 1989, registering two sole proprietorships under his control, without the knowledge or consent of CIS. Tr. 374, R. Ex. 53. McCormick testified that these assumed name certificates were filed when he realized there would be more "activity," presumably Ponzi scheme-related activity. Tr. 374. One of the assumed names was almost identical to the name of the respondent, Consolidated Investment Services, Inc. Stip. 5. McCormick subsequently opened an account at the Fort Bliss (Air Defense Center) Federal Credit Union in the name of himself and his doing business as designation Consolidated Investment Services Inc. Tr. 354. This account allowed McCormick to negotiate checks made out by Ponzi scheme investors to Consolidated Investment Services or CIS. Tr. 354.

Checks bearing both the names "The Ted McCormick Agency" and "Consolidated Investment Services Inc." were sent to CIS in connection with a mutual fund purchase executed by McCormick on behalf of Son Cha McCormick. D. Exs. 66 - 68. McCormick sent the checks in September and October 1988, knowing CIS officials had encouraged him not to open an account bearing the CIS name or a similar name. Tr. 378-79.18/ Fainter's claims that he did not recall seeing the checks is not credible

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18/ These checks showed that McCormick had an account that would permit him to personally negotiate checks made out to CIS. This facilitated the fraud, because it supported McCormick's representations that the Agency CDs were legitimate investments, executed through CIS and thereby insured under SIPC.

considering he acknowledged his initials were on the CIS transmittal and account application for Division Exhibit 68. Tr. 181. Similar initials appeared on Division Exhibits 66 and 67. Fainter agreed with the Division that if he had noticed unauthorized checks bearing the name Consolidated Investment Services Inc, it "would have set of all sort of alarm bells." Tr. 181. Rounds stated that McCormick would likely have been fired had someone at CIS seen these checks. Tr. 134. According to Rounds, copies of the checks were retained with the investment purchase documents in CIS files. Tr. 126. Such copies would have been readily available for review by Rounds as president, or any other official at CIS. These checks, which were red flags of a blatant violation of CIS policy and should have reasonably created suspicion about McCormick's activities, did not trigger any action by Rounds or Fainter.19/

As indicated, the "red flags" did not trigger specific supervisory actions by CIS supervisors against McCormick. McCormick was supervised no differently from others similarly situated at CIS. The largely non-existent supervision of the one man offices was equally applicable to McCormick. During his employment, McCormick was subject to a compliance program Respondents contend in substance constituted adequate supervision. The compliance program, administered by the compliance officer,20/ included the following principal components at the time of McCormick's employment:

19/ CIS has found one other registered representative using an account in the name CIS when he sent a check to the home office. Tr. 696. As a result of this red flag, the firm "put the [registered representative] under further surveillance as it relates to that matter and other matters." Id. No explanation was offered as to why McCormick's check was not detected by the system and similar action taken by CIS with respect to him.

20/ CIS employed Mr. Jake Kuijper as compliance officer from April 1984 though March 1991. Tr. 484-85. Kuijper reported to Rounds as his immediate supervisor, and upon Kuijper's termination in 1991 Rounds assumed the responsibilities of compliance officer. Tr. 702.

(i) a compliance or agents manual, which stated such information as the role of various members of the organization and the responsibilities of employees of CIS (D. Exs. 35-38); (ii) annual compliance questionnaires, which were completed by the registered representatives and reviewed by the compliance officer (D. Exs. 42, 44-46); (iii) annual compliance meetings, whereby registered representatives met centrally or individually with the compliance officer to discuss compliance issues (Tr. 520-21); (iv) ad hoc review and approval of letterhead, business cards, and marketing materials (Tr. 160-61, 284, 536-37); and (v) daily review of the firm's securities transactions. (Tr. 554-55, D. Ex. 35, fifth page (responsibilities of senior vice president)).

The CIS compliance program did not include: (i) surprise office inspections (Tr. 544); (ii) inspections of "non-branch" offices (Tr. 544); (iii) contact with the customers involved in the last five securities transactions listed by the registered representative in the annual compliance questionnaire, or any other compliance related contact with customers (Tr. 174, 497); and (iv) specific supervisory or compliance procedures for registered representatives with prior disciplinary history in the securities industry (Tr. 719).

In evaluating these practices of respondents, which they deem were adequate supervision, the analysis will now focus on the supervision practices applied to McCormick, and whether those practices were established and executed with a view to preventing securities law violations.

While the standard of reasonableness is largely subjective or "reasonable . . . under the attendant circumstances." Arthur James Huff, 48 SEC Docket 887, 883, industry practices and policies can be helpful in evaluating whether supervisory procedures meet the standard. These practices and policies provide some

of the circumstances under which the program is developed and executed. The Division argues respondents failed to apply to McCormick the industry practice of surprise inspections of off-site registered representatives. Div. Brief at 19. In support of the argument that such inspections represent a minimum industry standard, the Division asserts that: (i) the NASD Notice to Members issued in 1986 strongly urges that broker-dealers should conduct surprise inspections (D. Ex. 59); (ii) a representative of the NASD with substantial regulatory experience opined that a broker-dealer having no inspections of off-site representative was "very difficult to justify" and "inexcusable" for a representative with a disciplinary history like McCormick's (Tr. 217); and (iii) Waddell & Reed, a firm McCormick worked for a substantial amount of time prior to CIS, conducted, according to McCormick, inspections every one to two months which included inspecting the files, downloading the computer, calling clients and reviewing compliance letters (Tr. 273).

Respondents admit that after April 1989 McCormick's office was a "branch office" as defined by the NASD, and was thus required to be inspected on a cycle identified in firm's compliance manual. Resp. Brief at 17-18. Further, respondents concede that McCormick's office was not inspected substantively. Resp. Brief at 17. Respondents argue, however, that their failure to inspect McCormick's office does not constitute a failure to supervise, because inspection of the office could not have reasonably uncovered McCormick fraud and thereby prevented investor losses. Relying on the case of Kravitz v. Pressman, Frolich and Frost, Inc., 447 F. Supp. 203, respondents assert that the appropriate standard is whether the supervision would have

prevented the loss.21/ Respondent's reliance on this authority is misplaced and overstates the propositions on which the case rests. Kravitz and the cases on which the court relies involve the controlling person liability provisions of Section 20 of the Exchange Act, not the broker-dealer supervision requirements of Section 15 of the Exchange Act.22/ The "good faith" requirement of section 20 has been interpreted to be satisfied when it is "shown that the controlling person maintained and enforced a reasonable and proper system of supervision and internal control over controlled persons so as to prevent, as far as possible, violations of § 10(b) and Rule 10b-5." Zweig v. Hearst Corp., 521 F.2d 1129, 1134-35 (9th Cir. 1975). On its face, the broker-dealer supervision statute (section 15(b)(4)(E) and 15(b)(6)(A)) provide a much clearer statement of the applicable standard, namely whether a broker-dealer or associated person has "failed reasonably to supervise, with a view to preventing violations of the provisions of [the securities statutes and rules], another person who commits such a violation . . . ." unless "there have been established procedures and a system of applying such

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21/ Respondents cite for this principle a note from Kravitz in its holding finding a failure to supervise under the Exchange Act § 20(a) controlling person liability provisions:

> The facts here . . . are distinguishable from those in *SEC v. Lums*, [365 F. Supp. 1046 (1973)] . . . where the brokerage house was not held liable when the court could not construct any system of supervision that would have prevented the injury that occurred.

Kravitz, 447 F. Supp. 203, 214 n.16 (D. Mass. 1978).

22/ Section 20(a) of the Exchange Act provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this Act or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person is liable unless the controlled person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Exchange Act § 20(a).

procedures, which could reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person." Exchange Act Section 15(b)(4)(E). Under section 15(b), this court must only determine whether the supervisory procedures and system of applying such procedures could have reasonably been expected to prevent and detect McCormick's fraudulent activities. The preponderance of the evidence proves that adequate red flags existed which were reasonably obvious. CIS could have prevented the fraud if supervisory controls were installed to detect these violations, and the system of implementation had been adequate in detecting the violations through follow-up. Unfortunately for McCormick's victims, the supervisory system failed to detect the red flags, or the supervisors chose to ignore them.

McCormick operated with a known disciplinary history, from a distant office, as an independent contractor, among a group of initially 50 to 75 other widely dispersed individuals operating under similar circumstances. Ordinary business prudence dictates such operations should be monitored and physically examined periodically. Given the growth of CIS during McCormick's employ, the firm and its principals should have realized "the need for central control increases as branch offices become more numerous, dispersed and distant." William E. Parodi, Sr., 44 SEC Docket 1337, 1346 (1989). Instead, they ignored McCormick, knowing full well that in the brokerage business "[t]he opportunity and temptation to take advantage of the client is ever present." Zweig v. Hearst Corp., 521 F.2d 1129, 1135. During McCormick's entire five year tenure, his office was only once visited, but not inspected, by Fainter in August 1987. Tr. 66, 168. The visit was not intended and did not include the office or its records, and no evidence was presented of a report of the visit or inspection. Tr. 169,

172. One visit over five years was not a substitute for an adequate or reasonable supervisory practice of the cyclical inspection required by the NASD at the time. While the inspection may not have found fraud "coming out of the filing cabinets" as Ms. Whelan suggested (Tr. 224), it would have yielded pertinent information regarding McCormick's sales practices, advertisements used by McCormick (by looking in the local paper), the level of sales activity, and perhaps even documentation related to the Ponzi scheme. All of this could reasonably be anticipated to be discovered, thereby raising more red flags, particularly with a surprise inspection. Further, inspections, surprise or otherwise, would have helped prevent the fraud or the extent of the fraud committed, because McCormick would have been more concerned about his activities being detected.

Adding to the lack of any inspections was the respondents' failure to exercise reasonable supervisory practices from the home office. Respondents' compliance program relied heavily on the annual compliance questionnaires completed by the registered representatives.23/ Tr. 107; D. Exs. 42, 44-46. Respondents concede the purpose of these questionnaires was not to detect fraud. Resp. Brief at 13. Compliance officer Kuijper reviewed a "high percentage" of the questionnaires during the time he was employed by CIS, and he did nothing to verify the truthfulness of questionnaire

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23/ In its opinion regarding the matter of Respondents' supervision of registered representative Randy Romero, the NASD District Business Conduct Committee (DBCC) faulted CIS, Rounds and Fainter for "substantial reliance on compliance questionnaires to monitor the activities of its registered representatives [which] was unreasonable." The NASD DBCC further stated that they "did not believe the respondents took their supervisory responsibilities seriously." D. Ex. 51, page 21. This finding has no value as precedent in the instant case.

responses unless an answer was "wrong."24/ Tr. 496-98. Rounds and Fainter did not feel further inquiry was needed based on the questionnaires because they did not "expect reps to lie." Tr. 107-8, 727. As part of the questionnaire, registered representatives were asked to list their last five securities transactions, partly to detect any "selling away." Tr. 688. Kuijper, as part of his review of the annual questionnaires, did not as a practice contact customers listed in the last five transactions, and Rounds did not think such contacts were an effective policy. Tr. 498, 697. McCormick responded to a compliance questionnaire each year he worked at CIS. Tr. 364. He never disclosed in his responses to those questionnaires that he was conducting a Ponzi scheme, thus "selling away" fictional securities. Tr. 364. Such responses were untruthful. In three year's listings of "last five securities transactions." a majority of investors listed for legitimate securities transactions were also Ponzi scheme investors. D. Ex. 44, 46, 47; Tr. 364-65. A reasonable system of follow-up to these questionnaires, involving calls to at least some of the clients listed in the last five securities transactions, would have been a practice that would have helped CIS to prevent securities law violations by its registered representative. Particularly for McCormick, given his prior experience with client funds at Waddell & Reed, follow-up calls were essential. In the instant case, such calls may have reasonably detected the fictional Agency CD investments at the earliest stages of McCormick's scheme.

The most blatant and unexcusable evidence of a failure to supervise McCormick is traced to Respondents' failure to react to its own on-site files and records which contained obvious red flags. McCormick, during his employment by CIS, corresponded

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24/ Needless to say, reasonable supervision would require a review of all the questionnaires. This assumes the unproven proposition that the questionnaires were effective.

with CIS headquarters on noncomplying stationary bearing only his El Paso address.25/ D. Ex. 34. He filed a form U-4, and fully disclosed his regulatory history, reflecting discipline for improprieties, when he began his employment. D. Ex. 30. Further, the NASD sent letters to Rounds regarding McCormick's disciplinary problems as information necessary for meeting supervisory responsibilities. D. Exs. 31 & 32. McCormick sent checks bearing both the names "The Ted McCormick Agency" and "Consolidated Investment Services Inc." to CIS, for investments purchased by his wife. D. Exs. 66-68. Those checks were photocopied and attached to the Transmittal letter signed as approval by Fainter. Records of McCormick's net commissions were kept by CIS personnel, as evidenced by Division Exhibit 72. The respondents unreasonably failed to take supervisory action considering all of these red flags.

CONCLUSIONS AND SANCTIONS

Violation of sections 15(b)(4)(E) and 15(b)(6)(A) is predicated on: (i) an underlying securities law violation; (ii) association of the registered representative with the broker-dealer and associated persons; (iii) supervision responsibility over that person; and (iv) failure to reasonably supervise the person who violated the securities laws. Under a standard of reasonableness considering whether supervision was conducted with a view to preventing securities law violations, the broker-dealer's specific procedures and practices applicable to the individual representative are evaluated.

It is concluded that registered representative Theodore McCormick violated section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5

25/ Such stationary, like the business cards, frustrates the clients efforts to verify the Ponzi scheme transaction.

thereunder while he was employed by and registered with Consolidated Investment Services, Inc. He violated these provisions by selling fraudulent, non-existent securities known by names such as Agency CD Notes while conducting a Ponzi scheme. McCormick was supervised by Respondents Norman Rounds and James Fainter during his employment at CIS. Rounds and Fainter, as well as the broker-dealer CIS,26/ failed to reasonably supervise McCormick with a view to preventing his securities fraud, in violation of section 15(b)(4)(E) of the Exchange Act. Respondents' supervision was characterized by lax oversight of McCormick, who had a background of recent complaints in the securities business and was operating from a distant, "one-man" office which was required to be inspected but was not. Many "red flags," as discussed above, concerning McCormick's operations were raised during the course of McCormick's employment, yet none triggered inquiries or special supervisory practices. The respondents did not comprehend the seriousness of their supervisory responsibilities.

Once a respondent has been found to have violated the federal securities laws, it becomes necessary to consider what sanctions, if any, are contemplated by the statute and are in the public interest.

Section 15(b)(4)(E) of the Exchange Act provides that after finding a failure of a broker-dealer firm to reasonably supervise, an order shall be issued which censures, places limits on the activities of the broker-dealer firm, suspends the firm for a period not exceeding twelve months, or revokes the registration as a broker dealer if it is found to be in the public interest to do so. Section 15(b)(6)(A), applicable to associated persons of the broker-dealer rather than the broker-dealer firm, provides for the same

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26/ CIS is responsible for the failure to supervise McCormick based on the conduct of Rounds and Fainter. Douglass & Co., 46 S.E.C. 1189, 1193 (1978).

sanctions as section 15(b)(4)(E) except it authorizes a bar from association rather than revocation of registration, if such sanctions are found to be in the public interest.

In assessing sanctions, due regard must be given to the facts and circumstances of each particular case, since sanctions are not intended to punish a respondent but to protect the public from future harm. See Berko v. SEC, 316 F.2d 137, 141 (2d Cir. 1963), and Leo Glassman, 46 S.E.C. 209, 211 (1975). Sanctions should also serve as a deterrent to others. Richard C. Spangler, Inc., 46 S.E.C. 238, 254 n.67 (1976). In imposing administrative sanctions, the following factors should be considered:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that his occupation will present opportunities for future violations.

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981).

Further, under Exchange Act section 21B, which authorizes civil remedies in administrative proceedings, several considerations must be weighed if a money penalty is imposed. These considerations, some of which overlap the public interest factors enunciated in Steadman, include: (i) whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirements; (ii) the extent to which the act or omission directly or indirectly harmed another person; (iii) the extent to which any person was unjustly enriched as mitigated by any restitution; (iv) the regulatory history of the person; (v) deterrence; and (vi) other matters as justice may require. Exchange Act § 21B(b)(3)(C).

Consistent with Steadman and the factors listed under Exchange Act section 21B, the Division persuasively argues that the evidence supports substantial sanctions against Respondents, given the seriousness of broker-dealer supervisory responsibilities

compared to their minimal, laissez-faire approach to supervising McCormick. The Division submits that Rounds and Fainter should be (i) barred from associating with any broker or dealer, provided they may reapply for such association in a non-supervisory, non-proprietary capacity after three years; (ii) barred from association with all transfer agents, municipal securities dealers, investment advisers and investments companies, provided they may reapply for such association in a non-proprietary, non-supervisory capacity after three years; (iii) ordered to pay administrative penalties of $100,000 each authorized under section 21B(a)(4) of the Exchange Act; and (iv) CIS be ordered to cease and desist from committing or causing future violations of sections 15(b)(4)(E) and 15(b)(6)(A), pursuant to section 21C of the Exchange Act. As further sanctions imposed on the broker-dealer firm CIS, the Division submits: (i) the registration of CIS should be suspended for thirty days; (ii) employment of registered representatives not supervised on-site by a registered principal or subjected to semi-annual surprise inspections be prohibited for a period of five years; (iii) CIS be ordered to pay to pay administrative penalties of $100,000; and (iv) cease and desist from committing or causing future violations of relevant Exchange Act provisions. Following is a discussion of the public interest and other factors considered by the court in imposing appropriate sanctions.

Respondents repeatedly characterize the sanctions as Draconian. They assert that such sanctions would leave the broker-dealer "gutted" and leave its principals "effectively destroyed and deprived of their livelihood indefinitely." Resp. Brief at 6. The respondents imply in their brief that the broker-dealer should not be so penalized, when McCormick's "credulous" investors "ignored palpable inconsistencies" when investing in his scheme. In the imposition of sanctions, the Respondents must be reminded that it is not investors who are tasked with the serious duty of identifying

irregularities and supervising registered representatives, but rather the broker-dealer and its principals under Exchange Act sections 15(b)(4)(E) and 15(b)(6)(A).

The Division argues that Respondents' failure to supervise McCormick was particularly egregious. Such a failure is particularly acute since investors "are entitled to receive proper treatment and to be protected against fraud and other misconduct, and may properly rely on the [securities] firm to provide this protection." Reynolds & Co., 39 S.E.C. 902, 917 (1960). I agree with the Division's assessment of the egregiousness, as respondents demonstrated at the hearing the level of "buck-passing" which characterized their compliance program, a tendency which created a fertile ground for McCormick's Ponzi scheme. Their abdications of supervisory responsibilities was recurrent in that it spanned the entire time of McCormick's employment; his time at CIS was not marked by ebbs and flows of supervisory vigor, rather on-going confusion as to who served as his supervisor.

The Division strongly urges the deterrence value of significant sanctions against Respondents for supervisors of broker-dealer firms similar to CIS. In particular, strong sanctions may deter principals of other firms from setting up unmanageable networks of distant registered representatives, and then attempting to wash their hands of supervisory duties with regard to those representatives. The protection of investors is paramount, and the broker-dealer is obligated to ensure that protection through appropriate and effective supervision. The broker-dealer and its principals are the first line of defense in protecting investors from unscrupulous representatives. If we cannot rely on the firms and their principals to regulate their own employees, an undue burden is shifted on the regulatory authorities to police the industry. Strong sanctions against the Respondents in this case puts other broker-dealers and supervisors on notice of the costs associated

with cutting corners in the supervision area.

Respondents were not new-comers to the securities business. Tr. 24, 143. They knew, or should have known, the temptations a registered representative faces when handling investor funds. While Rounds stated the brokerage business operates on trust (Tr. 709) and they did not "expect reps to lie" (Tr. 108), he knew or should have known that trust can only go so far when supervising distant registered representatives with disciplinary histories. At the time of McCormick's employment, Rounds and Fainter had "a lot of things going on" (Tr. 136) which included servicing their own clients and managing CIS. I find Respondents intentionally, deliberately and recklessly cut corners in the supervisory area in order to maximize their returns from CIS. As was the temptation too great for McCormick in handling investor funds, so too was the temptation too great for Rounds and Fainter to ignore their supervisory responsibilities and shift their activities to higher payoff activities.

Relevant to the public interest determination is respondents' recognition of the wrongful nature of their conduct. Their demeanor at the hearing and their obvious finger-pointing in their testimony betray their lack of contrition. Further, respondents condescending attitude toward the investors whom they are tasked with protecting under the supervision provisions of section 15(b) indicates the danger of allowing them to continue in the business. They never conceded in the record that they inadequately supervised McCormick, although they intimated that each other failed to supervise. No mitigating factors were presented to offset the Rounds and Fainter's lack of contrition.

Rounds continues to work in the securities business in supervisory and proprietary capacities for several organizations. Tr. 27-31. Fainter continues as a registered principal of CIS (Answer, para. II.B.), however it is apparent from the record that his

involvement in supervisory matters there is limited. Rounds' multiple holdings and functions of president and vice-president makes it more likely he may violate his obligation to supervise in the future. Both appear, at least through their testimony at the hearing and despite their long participation in the industry, naive about the possibility of fraud.27/ Such naivete', whether real or manufactured, is dangerous for principals tasked with supervising registered representatives.

Several factors militate in favor of the Respondents in considering what sanctions are appropriate and in the public interest. It appears from the testimony of Rounds and Fainter that the McCormick and similar Romero incidents have compelled them to improve their supervisory practices. According to Rounds, CIS has strengthened its compliance staff with two in-house attorneys and a full-time compliance person, they have several people review transactions as opposed to one at the time of McCormick's employment, and they now conduct surprise inspections of registered representatives as a matter of policy. Tr. 66-67, 706. Further, Rounds recognizes that supervisory practices should be custom-tailored to fit the circumstances of individual representatives, and should thus be expected to do so in the future. Tr. 64. Fainter pointed out that customer files and compliant files are now checked as a "now . . . a very obvious step in the inspection" of registered representative's offices. Tr. 186. With the imposition of appropriately tailored sanctions, it can be reasonably assured that these steps to improve supervisory practices will be carried out effectively in the future. Lastly, Respondents derived no pecuniary gain from McCormick's activity, as none of his

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27/ Fainter thought McCormick, with his past history with bad checks and misappropriating customer funds, posed no greater or lesser risk than any other registered representative. Tr. 716. Rounds did not expect representatives to lie and said the business operated on trust. Tr. 108, 709.

transactions were cleared through CIS. Stip. 3, DPFF at 2.

Taking into account all of these public interest factors,28/ it is considered in the public interest that: Rounds be barred from association with any broker-dealer with a right to reapply after one year, cease and desist from committing or causing future violations of sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act pursuant to section 21(C) of the Exchange Act, and pay an administrative penalty of $50,000 pursuant to section 21B(a)(4);29/ Fainter be barred from association with any broker-dealer, with a right to reapply after one year, cease and desist from committing or causing future violations of Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act; and pay an administrative penalty of $50,000; and the registration of CIS be suspended for thirty days, upon the end of that suspension the firm will be prohibited from employing registered representatives not supervised on-site by a registered principal or subjected to semi-annual surprise inspection, and the firm will pay a penalty of $50,000.30/

28/ I also have taken into account Respondents' regulatory histories, including an NASD decision finding a failure to supervise a registered representative (D. Ex. 51), an 1989 action against Fainter by the state of Colorado alleging misconduct (D. Ex. 69), and a 1990 sanction by the state of Michigan against CIS for selling unregistered securities (D. Ex. 70). Such factors are relevant in the fashioning of sanctions. See Steadman, 602 F.2d at 1140; Exchange Act § 21B(C)(4).

29/ I found Respondents' activity with respect to McCormick to be in reckless disregard of the supervisory requirements under section 15(b)(4)(E). Further, McCormick's scheme resulted in nearly $2.3 million in investor losses, for which little restitution has been paid. These factors are relevant in determining that the maximum administrative penalty which can be imposed in this case under Exchange Act section 21B(b)(3) is $100,000 for Rounds and Fainter and $500,000 for CIS. The militating factors discussed supra indicate the maximum penalty is not warranted in this case.

30/ The Division also requested collateral bars be imposed against Rounds and Fainter for failure to supervise under section 15(b)(6)(A) of the Exchange Act. Such sanctions would bar Respondents from all facets of the securities industry. These sanctions are (continued...)

ORDER

IT IS ORDERED that pursuant to Sections 15(b), 19(h) and 21B of the Exchange Act the registration of Consolidated Investment Services, Inc. be suspended for thirty days, upon the end of that suspension the firm will be prohibited from employing registered representatives not supervised on-site by a registered principal or subjected to semi-annual surprise inspection, and that the firm will pay a penalty of $50,000.31/

IT IS FURTHER ORDERED that Norman P. Rounds and James L. Fainter, pursuant to Sections 15(b), 19(h), 21C and 21B of the Exchange Act be barred from association with any broker-dealer with a right to reapply after one year, cease and desist from committing or causing future violations of Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act, and pay a penalty of $50,000.

These sanctions are imposed as necessary and appropriate in the public interest, for the protection of investors.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commissions Rules of Practice.

Pursuant to 17(f) of the Rules of Practice, this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision

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30/(...continued)
not an appropriate remedy in this case, and in my view such actions cannot be taken in a proceeding under section 15(b).

31/ The administrative money penalties ordered in this decision should be paid by certified check payable to the "SECURITIES AND EXCHANGE COMMISSION," bearing on its fact the caption "Consolidated Investment Services," and the file number 3-8312 for the case, to be sent to the United States Securities and Exchange Commission, Office of the Comptroller, Room 2067, Stop 2-5, 450 5th Street, N.W., Washington, D.C. 20549, within thirty (30) days of the entry of the Order.

pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party files a petition for review, or the Commission takes action as to a party, the Initial Decision shall not become final with respect to that party.

Glenn Robert Lawrence
Administrative Law Judge

Washington, D.C.
December 8, 1994
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