

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 66114 / January 6, 2012

Admin. Proc. File No. 3-14307

In the Matter of the Application of

WORLD TRADE FINANCIAL CORP.,
JASON TROY ADAMS, FRANK EDWARD
BRICKELL, and RODNEY PRESTON MICHEL
c/o John Courtade, Esq.
Law Office of John Courtade
4408 Spicewood Springs Road
Austin, TX 78759

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY
PROCEEDING

Unregistered Sales of Securities

Conduct Inconsistent with Just and Equitable Principles of Trade

Failure to Establish Written Supervisory Procedures

Failure to Supervise

Member firm of registered securities association and registered representative engaged in unregistered sale of securities in violation of Securities Act and association's rules. Member firm, its president, and its trading supervisor failed to reasonably supervise firm's registered representative engaging in unregistered sale of securities. Member firm and president also failed to maintain adequate written supervisory procedures. *Held*, association's findings of violations and sanctions imposed *sustained*.

APPEARANCES:

John Courtade, of the Law Office of John Courtade, and *Irving Einhorn*, of the Law Offices of Irving Einhorn, for *World Trade Financial Corp.*, *Jason Troy Adams*, *Frank Edward Brickell*, and *Rodney Preston Michel*.

Marc Menchel, Alan Lawhead, and Leavy Matthews III, for Financial Industry Regulatory Authority, Inc.

Appeal filed: March 24, 2011

Last brief received: August 11, 2011

I.

World Trade Financial Corporation ("World Trade" or the "Firm"), a FINRA member firm,¹ and three persons associated with it, Rodney Preston Michel, its president, Jason Troy Adams, its trade desk supervisor, and Frank Edward Brickell, a registered representative (collectively, the "Applicants"), appeal from a FINRA disciplinary action.² FINRA found that World Trade and Brickell unlawfully sold securities without registration or an available exemption in violation of Section 5 of the Securities Act of 1933 and NASD Conduct Rule 2110. In connection with these sales, FINRA also found that World Trade, Michel, and Adams failed reasonably to supervise Brickell and that World Trade and Michel failed to maintain adequate written supervisory procedures in violation of NASD Conduct Rules 3010 and 2110.³

For the registration violations, FINRA fined World Trade \$15,000, fined Brickell \$15,000, and suspended him in all capacities for thirty business days. For the supervisory violations, FINRA fined World Trade \$30,000, fined Michel \$30,000 and suspended him for forty-five calendar days, and fined Adams \$20,000 and suspended him for thirty business days. FINRA also imposed administrative costs. We base our findings on an independent review of the record.

¹ On July 26, 2007, the Commission approved a proposed rule change NASD filed reflecting its name change to Financial Industry Regulatory Authority, Inc. ("FINRA"), in connection with its consolidation of regulatory functions with NYSE Regulation, Inc. *See* Securities Exchange Act Rel. No. 56148 (July 26, 2007), 91 SEC Docket 522. Because this matter was instituted after consolidation, references to FINRA include references to NASD.

² FINRA's complaint also charged similar violations against two other member firms and various associated persons for their sale of iStorage stock, although none of the firms or associated persons were alleged to have been related. Midas Securities, LLC, and its president also appeal from the underlying FINRA decision. That appeal is pending.

³ NASD Conduct Rule 2110 requires members to observe "high standards of commercial honor and just and equitable principles of trade." FINRA has since recodified NASD Rule 2110 as new FINRA Rule 2010, without substantive change. *See* Exchange Act Rel. No. 58643 (Sept. 25, 2008), 73 Fed. Reg. 57,174. NASD Conduct Rule 3010, as discussed *infra* in notes 57-60 and accompanying text, requires members to have adequate written procedures as well as a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."

II.

The facts are largely undisputed.⁴ During the period from December 2004 to March 2005, World Trade sold 2.3 million shares of a thinly traded penny stock, iStorage, Inc. ("iStorage"), on behalf of three customers who held accounts with World Trade. iStorage's securities traded in the over-the-counter market and were quoted on the "Pink Sheets."⁵ Brickell admitted that he sold the iStorage shares for the customers. The transactions were not registered with the Commission.

A. World Trade

World Trade is a registered broker-dealer, headquartered in San Diego, California. At all relevant times, Michel and Adams were principals and part owners of the Firm, and Brickell was a registered representative.⁶ Since becoming a FINRA member in 1998, World Trade's business has consisted almost entirely of the purchase and sale of securities on behalf of customers in the over-the-counter market. A large part of that business comprises the unregistered sale of securities for customers based on their unsolicited orders.

Michel's duties as president included developing the written procedures that were in effect at the Firm. According to the Firm's Supervisory Procedures Manual (the "Supervisory Manual"), Michel had "responsibility for establishing supervisory systems and overall oversight of compliance functions." Michel's and Adams's testimony indicated that they shared responsibility for supervising the Firm's registered representatives and trading activity. Their supervision included reviewing monthly account statements, trade blotters, and stock certificates that customers deposited, and conducting periodic "spot checks" of trade confirmations. According to the supervisors' testimony, Adams handled more of the day-to-day supervision of the Firm's trading activity and reported to Michel.

⁴ The parties stipulated to many facts at issue in this case. *See generally James F. Glaza*, 57 S.E.C. 907, 914 (2004) ("[S]tipulated facts serve important policy interests . . . [and] should not be set aside without a showing of compelling circumstances.").

⁵ The "Pink Sheets," now known as OTC Link, is an electronic quotation system, operated by OTC Markets Group Inc., which displays quotes and last sale information for many over-the-counter securities. At the time of the stock sales in question, the Pinks Sheets did not have any listing requirements for companies whose securities were quoted on its system.

⁶ According to the parties' stipulations, Brickell is now a principal at the Firm, serving as its chief compliance officer.

The Supervisory Manual had written procedures applicable to the sale of "control" or "restricted" stock. The Supervisory Manual did not define either term, but characterized both as "144 Stock."⁷ The Supervisory Manual contained a list of conditions to meet before a representative could sell such securities:

1. There must be current information available to the public about the company;
2. In some instances, only a limited quantity of the stock can be sold in any three-month period;
3. The securities must be sold in a broker transaction or directly to a market maker;
4. In some instances, a notice must be transmitted to the SEC and . . . [the relevant stock exchange].
5. In the case of restricted stock, the stock must have been owned and fully paid for a specified period of time; and
6. The certificates of the stock must have been re-issued free of any restrictive legends.

In addition, personnel were required to contact Adams and "obtain the necessary documentation from the customer" before executing the transaction, although the Supervisory Manual did not define "the necessary documentation."

Adams and Michel testified that, in practice, the Firm's registered representatives identified "control" and "restricted" stock by checking whether the stock certificate deposited by the customer bore a restrictive legend.⁸ According to Adams, a stock certificate that lacked a restrictive legend meant the stock was "free trading," "not restricted," and could be readily resold to the public, while a stock certificate that bore a restrictive legend would be handled "through the [Rule] 144 process" by the registered representative who would undertake efforts "to remove

⁷ Rule 144 of the Securities Act provides a non-exclusive safe harbor from registration for resales of restricted securities. 17 C.F.R. § 230.144. Rule 144 defines the term "restricted securities" to include "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering." 17 C.F.R. § 230.144(a)(3). The term "control securities," while not expressly defined by Rule 144, "is used commonly to refer to securities held by an affiliate of the issuer." *Revisions to Rules 144 and 145*, Securities Act Rel. No 8869 (Dec. 17, 2007), 92 SEC Docket 143, 145.

⁸ A restrictive legend is "a statement placed on restricted stock notifying the holder that the stock may not be resold without registration." *Charles F. Kirby*, 56 S.E.C. 44, 48 (2003), *petition denied sub. nom, Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004).

the legend." Michel testified that "the only procedures we have for stock without a legend is to submit them to a clearing firm to be cleared, transferred, and to be sold."

B. iStorage

The predecessor of iStorage was incorporated in 1997 as Camryn Information Services, Inc. ("Camryn"), a Delaware shell company. From 1999 until November 2004, Camryn's corporate charter was deemed void by the State of Delaware for non-payment of taxes. On November 3, 2004, Camryn entered into a reverse merger with iStorage, a development-stage company, that had been in operation since May 28, 2004.⁹ The resulting entity of the reverse merger was renamed iStorage.¹⁰

There was limited information available about iStorage on the Pink Sheets Web site at the time World Trade made the sales in question. iStorage described itself as a developer of "network storage solutions" that partnered with leading software and hardware providers. An unaudited financial statement reported that, as of October 31, 2004, iStorage had little operating history, no earnings, and a net operating loss of \$205,000. At the time of its merger with Camryn, iStorage had only four shareholders, all of whom were previous shareholders of Camryn. Three of the iStorage shareholders each owned 1,000,000, or 12.5%, of the outstanding and issued shares (the "12.5% Shareholders"), and the remaining iStorage shareholder owned 5,000,000, or 62.5%, of the outstanding shares (the "62.5% Shareholder").

Also in the online materials was a legal opinion, dated November 2, 2004 (before Camryn entered the reverse merger), from Bertsch & Associates, PC, a law firm representing the 12.5% Shareholders (the "Bertsch Legal Opinion"). The Bertsch Legal Opinion requested that Camryn's transfer agent,¹¹ Routh Stock Transfer, Inc. ("Routh Transfer"), remove the restrictive legends from the 12.5% Shareholders' Camryn stock certificates. In support of its request, the law firm stated that the shareholders had held the shares for "more than two years" and none had been "an officer, director or 10% shareholder of the company for the previous three months" and that,

⁹ Statement of Financial Accounting Standards No. 7 defines a development-stage company "as a business devoting substantially all of its efforts to establishing a new business in which either: (1) planned principal operations have not commenced, or (2) there have been no significant revenues therefrom." *Russell Ponce*, 54 S.E.C. 804, 806 n.9 (2000), *aff'd*, 345 F.3d 722 (9th Cir. 2003).

¹⁰ See *Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies*, Securities Act Rel. No. 8587 (July 15, 2005), 85 SEC Docket 3697, 3698 (discussing mechanics of a "reverse merger"); *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 344 & n.4 (S.D.N.Y. 1998).

¹¹ A transfer agent conducts various stock-related functions for an issuer, including recording changes of ownership, maintaining the security holder records, canceling and issuing stock certificates, and distributing dividends. See *Phlo Corp.*, Exchange Act Rel. No. 55562 (Mar. 30, 2007), 90 SEC Docket 1089, 1090-91.

under Securities Act Rule 144(k),¹² it believed the 12.5% Shareholders were not "affiliates" of Camryn.¹³

Although it was error for the Bertsch Legal Opinion to state that the 12.5% Shareholders' percentage of ownership in Camryn was less than 10% for the previous three months, Routh Transfer subsequently removed the restrictive legends from their Camryn stock certificates.¹⁴ On November 3, 2004, iStorage issued a 3.334-to-1 forward stock split to the company's four shareholders, an action that more than tripled the number of their shares of what had become Storage stock. Thereafter, between November 9 and November 15, 2004, the 12.5% Shareholders conveyed up to 5.2 million of their iStorage shares to various individuals and entities, several of which were stock promoters and marketers. The shares of the 62.5% Shareholder were canceled at the time.¹⁵

In late December 2004, FINRA began investigating possible market manipulation of iStorage's stock, after receiving several unsolicited bulk e-mails or "spam," from an unidentified source, touting iStorage's stock. The e-mails heralded iStorage as an "UNDISCOVERED STOCK GEM," claimed that a "big PR campaign [was] underway," and encouraged recipients of the e-mail to "GET IN NOW" because iStorage's share price was about to "EXPLODE."¹⁶ The spam campaign coincided with several upbeat press releases issued by iStorage at the time, beginning with its announcement on December 8, 2004, that its stock had started trading on the

¹² At the time, Securities Act Rule 144(k) permitted a non-affiliate, who had been a non-affiliate for the three-month period preceding the sale, to publicly resell restricted securities without being subject to any of the conditions in Rule 144 after holding the restricted securities for a period of at least two years, as computed in accordance with Rule 144(d). Rule 144(k) has since been repealed and replaced by Rule 144(b). *Revisions to Rules 144 and 145*, 92 SEC Docket at 145 & n.23.

The record indicates that Bertsch & Associates, in addition to representing the 12.5% Shareholders, was a direct beneficiary of the removal of the restrictive legends, having acquired 227,000 iStorage shares from its clients that it later resold to the public through another broker-dealer for \$27,742, without registration.

¹³ An "affiliate" of an issuer is defined as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1).

¹⁴ See *infra* note 52 and accompanying text.

¹⁵ The 62.5% Shareholder's iStorage shares were canceled on November 15, 2004, when the individual resigned as iStorage's president.

¹⁶ Emphasis in original.

Pink Sheets. Other press releases followed in rapid succession, announcing that the company had secured several large purchase orders and expanded to global markets.

During the first month of iStorage's trading, iStorage averaged a daily trading volume of 357,781 shares. iStorage's stock began selling on December 9, 2004, at \$0.65 per share. Its share price fell to \$0.13 by year end and continued declining to \$0.05 by February 2005. By March 24, 2005, over 3.7 million iStorage shares had been publicly sold in the over-the-counter market without registration.

C. The Unregistered Sales of 2.3 Million Shares of iStorage Stock

It is undisputed that, from December 20, 2004, to March 24, 2005, World Trade, through Brickell, sold more than 2.3 million shares of iStorage stock to the public on behalf of three customers—Robert Koch, Anthony Caridi, and Kimberly Koch—who had received those shares from the 12.5% Shareholders. Specifically, Brickell conducted the following sales:

- On fourteen days, between December 20, 2004, and January 7, 2005, he sold a total of 1,456,800 iStorage shares for Robert Koch.
- On twenty-eight days, between December 22, 2004, and March 7, 2005, he sold a total of 746,000 iStorage shares for Caridi.
- On four days, between December 22, 2004, and March 24, 2005, he sold a total of 108,000 iStorage shares for Kimberly Koch.

The transactions yielded approximately \$295,000 in sales proceeds, which Brickell wired to the customers shortly after the sales cleared. Brickell earned approximately \$9,270 in commissions on the sales.

At FINRA's hearing, Brickell testified that, at the time of the transactions, he knew Robert Koch was a stock promoter who founded and managed Dailyfinancial.com ("Daily Financial), a stock promotion Web site "where [Robert Koch] . . . posted profiles" and press releases of companies that sold on the Pink Sheets and OTC Bulletin Board. Brickell admitted that he also knew that Caridi and Kimberly Koch worked at Daily Financial: Caridi as a stock promoter and Kimberly Koch as a personal assistant to her brother, Robert.¹⁷ Brickell also understood that all three customers received stock as compensation from companies that Daily

¹⁷ In September 2006, in an unrelated proceeding, Robert Koch pleaded guilty to criminal securities fraud for engaging in a "pump and dump" scheme in 2004–2005, involving another penny stock, in which Koch admittedly used spam and misleading press releases to artificially inflate the stock. In September 2011, Koch pleaded guilty to additional securities fraud charges for conduct occurring from 2006–2008 with respect to another penny stock. He awaits sentencing. *United States v. Koch*, S1 06 Cr. 902 (RWS) (S.D.N.Y. filed Sept. 29, 2006).

Financial promoted and that they intended to use their World Trade accounts to liquidate this stock.

The three customers' World Trade accounts were open less than four months¹⁸ when they deposited large blocks of iStorage shares into their accounts and requested that the shares be liquidated. Robert Koch made the first deposit in the amount of 2.8 million shares on November 26, 2004, followed by Caridi's deposit of 746,000 shares on December 2, and Kimberly Koch's 200,000 shares on December 20. Each customer deposited at World Trade a single stock certificate issued by iStorage on November 15, 2004, which did not have a restrictive legend.

As part of Applicants' stipulations, Brickell admitted that he "knew or should have known" that iStorage at the time was a "little-known development stage issuer that had a very short operating history," that it recently underwent a "reverse merger, forward stock split and name change," that it was "thinly traded in the over-the-counter market," and that the stock "just began trading shortly before the initiation of trading by [his] customers."

He testified that, because his customers' stock certificates lacked a restrictive legend, he conducted no inquiry about iStorage before selling the stock. He also acknowledged that, although his customers sought to sell a large block of recently issued shares, he did not ask them how they acquired the shares, what percentage of iStorage stock they owned, or whether they were associated or affiliated with iStorage, the issuer of the stock. Brickell also acknowledged that he took no steps before selling iStorage stock to determine whether the proposed sales were registered with the Commission or whether the iStorage stock could be sold under an exemption from registration.

Brickell instead maintained throughout his testimony that he relied on iStorage's transfer agent, Routh Transfer, and World Trade's clearing firm to conduct any required due diligence when they processed his customers' stock certificates. He expressed the belief that his responsibility for conducting the sales was limited to "asking [the transfer agent] whether or not [the stock was] free trading or if any stops or restrictions [existed] that would prevent the shareholder from transferring or selling." Brickell testified that, while he recalled reviewing some of the online information, including the Bertsch Legal Opinion, "a day or two after" trading the stock, he did not rely on such information when selling the shares.

¹⁸ According to the parties' stipulations, Robert Koch opened an account with World Trade in August 2004; Caridi, in November 2004; and Kimberly Koch, in December 2004.

In March 2005, in response to a FINRA information request, World Trade stated that the Firm "did not conduct any due diligence research on Istorage [sic]." In their "Wells" submission on December 18, 2006,¹⁹ Applicants explained that they conducted no inquiry because they relied on the transfer agent to determine whether the stock could be legally sold:

All brokers rely on the transfer agent for a determination as to whether stock is eligible for transfer. Indeed, without the transfer agent, a firm like World Trade has no way to ascertain whether any particular stock is restricted or not restricted. We are aware of no brokerage firm that has a mechanism for making this determination itself.

Applicants also denied having any "responsibility to determine if the certificates being deposited into the customer's account are part of an unregistered distribution," asserting that "the regulatory scheme places this responsibility squarely on the shoulders of the transfer agent and the issuer and its counsel." However, Applicants also stipulated that neither Routh Transfer nor the clearing firm considered itself responsible for conducting any inquiry on behalf of the Firm.

Adams testified that, as Brickell's supervisor, he was aware that the Kochs and Caridi were selling large blocks of recently issued iStorage stock and that the customers worked for a stock promoter. Adams, like Brickell, believed that the Firm had no responsibility to investigate the stock it sold for customers when there was no restrictive legend. Michel agreed, stating his assumption that the responsibility for conducting any due diligence of stock rested with "the transfer agent and with the attorney who wrote the opinion" to remove the restrictive legend. Accordingly, neither supervisor required Brickell to ask any questions of his customers regarding their proposed sale of iStorage, nor did they conduct any investigation of their own into Brickell's iStorage sales.

Applicants also admitted in their answer that World Trade had no written procedures addressing the circumstances under which its registered representatives should initiate an inquiry into the registration or exemption status of shares its customers proposed to sell. For instance, the written procedures did not include a list of risk factors to consider before conducting unregistered sales for customers, such as a little-known issuer, a thinly traded security, or deposit of a large volume of shares that may indicate a public distribution requiring registration.²⁰ The procedures also lacked any guidance to determine whether a proposed sale required registration or qualified for an exemption, such as asking the customer how, when, and under what circumstances the customer obtained the shares.

¹⁹ See FINRA Notice to Members 09-17 (discussing FINRA's "Wells Process" that allows a "potential respondent an opportunity to submit a . . . Wells Submission, which discusses the facts and applicable law and explains why formal charges are not appropriate").

²⁰ "The term 'distribution' refers to the entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hand of the investing public." *Geiger*, 363 F.3d at 487 (citation omitted).

D. FINRA's Proceeding

On March 3, 2011, FINRA's National Adjudicatory Council (the "NAC") affirmed a FINRA Hearing Panel's findings that World Trade's and Brickell's sale of 2.3 million shares of iStorage stock for their customers violated Securities Act Section 5 and NASD Rule 2110. The NAC also sustained findings that World Trade, Adams, and Michel failed to adequately supervise Brickell's securities trading and that World Trade and Michel failed "to establish and maintain a system and written procedures to ensure compliance with [Securities Act] Section 5's requirements" in violation of NASD Rule 3010 and Rule 2110.

In sanctioning the Applicants, the NAC upheld the suspensions imposed against Michel, Adams, and Brickell and the \$15,000 fines assessed against World Trade and Brickell for their registration violations, but increased the fines against World Trade, Michel, and Adams for their supervisory failures. The NAC, citing "several red flags that should have prompted an inquiry into whether iStorage shares were part of an unlawful distribution," fined World Trade and Michel each \$30,000 and Adams \$20,000. The NAC also prohibited the Firm "from receiving and selling unregistered securities until" it revises its written procedures to comply with Securities Act Section 5, based on a review by an independent consultant, acceptable to FINRA.

III.

A. Violations of Securities Act Section 5

1. Securities Act Section 5

Section 5(a) of the Securities Act prohibits the "sale" of any securities, in interstate commerce, unless a registration statement is in effect as to the offer or sale of such securities or there is an applicable exemption from the registration requirements.²¹ Securities Act Section 5(c) prohibits the "offer for sale" of any securities, unless a registration statement has been filed as to such securities or an exemption is available.²² The purpose of the registration requirements is to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions."²³ "This policy," we have stated, "is equally applicable to the distribution of a new issue and to a redistribution of outstanding securities which 'takes on the characteristics

²¹ 15 U.S.C. § 77e(a).

²² 15 U.S.C. § 77e(c).

²³ *SEC v. Ralston Purina*, 346 U.S. 119, 124 (1953); *see also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (stating that a fundamental purpose of the securities laws is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*").

of a new offering by reason of the control of the issuer possessed by those responsible for the offering."²⁴

A *prima facie* case for violation of Securities Act Section 5 is established upon a showing that (1) no registration statement was in effect or filed as to the securities; (2) a person, directly or indirectly, sold or offered to sell the securities; and (3) the sale or offer to sell was made through the use of interstate facilities or mails.²⁵ *Scienter*—*i.e.*, an intent to deceive—is not a requirement.²⁶

World Trade and Brickell concede that FINRA established a *prima facie* case for violations of Securities Act Sections 5(a) and (c) through their sale of iStorage shares, by interstate means, without a registration statement in effect or filed with the Commission.

2. The Section 4(4) Exemption

Exemptions from the registration requirements are affirmative defenses that must be established by the person claiming the exemption.²⁷ Registration exemptions "are construed strictly to promote full disclosure of information for the protection of the investing public."²⁸

²⁴ *Ira Haupt & Co.*, 23 S.E.C. 589, 595 (1946) (quoting Report of Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. H.R. Rep. No. 85 at 592 (1933)); *see also Pennaluna & Co.*, 410 F.2d 861, 865 (9th Cir. 1969) ("[T]he presumptive need for registration implicit in § 5 extends to all secondary distributions not insignificant in their proportions.").

²⁵ *SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006); *SEC v. Calvo*, 378 F.3d 1211, 1214-15 (11th Cir. 2004).

²⁶ *Calvo*, 378 F.3d at 1215; *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976).

²⁷ *See, e.g., Zacharias v. SEC*, 569 F.3d 458, 464 (D.C. Cir. 2009) (citing *Ralston Purina*, 346 U.S. at 126 ("Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable.")), *aff'g in relevant part, John A. Carley*, Exchange Act Rel. No. 57246 (Jan. 31, 2008), 92 SEC Docket 1693; *Swenson v. Engelstad*, 626 F.2d 421, 425 (5th Cir. 1980) (stating that Securities Act Section 4(2)'s private offering exemption "is an affirmative defense which must be raised and proved by the defendant." (collecting cases)).

²⁸ *Cavanagh*, 445 F.3d at 115; *see also SEC v. Murphy*, 626 F.2d 633, 641 (9th Cir. 1980) (same).

Evidence in support of an exemption must be explicit, exact, and not built on conclusory statements.²⁹

World Trade and Brickell claim that their iStorage transactions were exempt under Securities Act Section 4(4), which exempts "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."³⁰ We have stated that the Section 4(4) exemption, commonly known as the brokers' exemption, is designed to exempt "ordinary brokerage transactions" and is not available if the broker "knows or has reasonable grounds to believe that the selling customer's part of the transaction is not exempt from Section 5 of the Securities Act."³¹ Brokers thus have "a duty of inquiry" into the facts surrounding a proposed sale.³²

The amount of inquiry required necessarily varies with the circumstances of the proposed transaction, as we have explained:

[On the one hand,] [a] dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security . . . where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for.³³

²⁹ *Ronald G. Sorrell*, 47 S.E.C. 539, 541 n.8 (1981) (quoting *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971)), *aff'd*, 679 F.2d 1323 (9th Cir. 1982).

³⁰ 15 U.S.C. § 77d(4).

³¹ *Carley*, 92 SEC Docket at 1707; *see also Butcher & Singer, Inc.*, 48 S.E.C. 640, 642 (1987), *aff'd*, 833 F.2d 303 (3d Cir. 1987) (without opinion); *Quinn & Co.*, 44 S.E.C. 461, 467 (1971), *aff'd*, 452 F.2d 943 (10th Cir. 1971).

³² *Jacob Wonsover*, 54 S.E.C. 1, 13 (1999), *petition denied*, 205 F.3d 408 (D.C. Cir. 2000); *Robert G. Leigh*, 50 S.E.C. 189, 193 (1990); *Owen V. Kane*, 48 S.E.C. 617, 621 (1986), *aff'd*, 842 F.2d 194 (8th Cir. 1988); *cf.* Securities Act Rule 144(g)(4), 17 C.F.R. § 230.144(g)(4) (stating that the term "brokers' transactions" in Securities Act Section 4(4) would not be deemed to include, for purposes of Rule 144, transactions in which the broker does not conduct a "reasonable inquiry").

³³ *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Rel. No. 4445 (Feb. 2, 1962), 27 Fed. Reg. 1251 ("1962 Securities Act Release"); *see also Sales of Unregistered Securities by Broker-Dealers*, Exchange Act Rel. No. 9239 (July 7, 1971), 1971 SEC LEXIS 19 ("1971 Exchange Act Release") ("The customer's responses or other particular
(continued...)

This duty of inquiry extends to both the broker and the registered representative executing the transactions.³⁴ Both, as agents for their customers, "have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available."³⁵

Here, the customers deposited large blocks of a recently issued, little-known stock into their World Trade accounts and directed Brickell to sell the shares shortly thereafter without a registration statement in effect.³⁶ Given these circumstances, Brickell was required to conduct a searching inquiry to assure himself that his customers' proposed sales qualified for an exemption from registration and were not part of an unlawful distribution.³⁷ Brickell and World Trade, however, admit conducting no inquiry into their customers' proposed sales or how they acquired their shares, nor did they attempt to gather information about iStorage, the issuer of the stock. Had Applicants conducted even a cursory investigation of iStorage before selling the stock, the information on the Pink Sheets Web site should have raised red flags, showing iStorage to be a newly formed company that had been trading for less than two weeks, had little operating or earnings history, and had a negative balance sheet. By failing to conduct the necessary inquiry under the circumstances, Applicants have not met their burden of establishing that the Section 4(4) exemption applied to their iStorage sales.³⁸

³³ (...continued)

circumstances may reasonably indicate that there is a duty to make further inquiries and verify the information received. The most obvious situations are where a previously unknown customer may be seeking to sell a significant amount of securities and the issuer may be relatively unknown to the public.").

³⁴ *Leigh*, 50 S.E.C. at 193.

³⁵ *Stone Summers & Co.*, 45 S.E.C. 105, 108 (1972); *see also Paul L. Rice*, 45 S.E.C. 959, 961 (1975) (explaining that, while salespersons need not be "finished scholars in the metaphysics of the Securities Act . . . [,] familiarity with the rudiments is essential").

³⁶ *See Wonsover*, 54 S.E.C. at 13 n.25 ("A distribution within a relatively short period after acquisition is evidence of an original intent to distribute." (citing 1 L. Loss, *Securities Regulation* 552 (2d ed. 1961))).

³⁷ *See, e.g., Michael A. Niebuhr*, 52 S.E.C. 546, 550 (1995) ("[W]e have long stated, a 'searching inquiry' . . . is called for when a broker-dealer is offered a substantial amount of a little-known security"); *Gilbert F. Tuffli, Jr.*, 46 S.E.C. 401, 409 (1976) (holding a "searching" "inquiry is essential whenever a salesman is presented with a large block of an obscure stock").

³⁸ *Stone Summers*, 45 S.E.C. at 108-09 (finding the Section 4(4) exemption unavailable where "respondents made no serious effort to determine the source and the circumstances of the acquisitions of such stock and did not even question either of the sellers").

The customers' known stock promotion activities should have raised additional concerns that the sales were part of an unlawful distribution. A broker cannot rely on the Section 4(4) exemption when his customer is an "underwriter," defined as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security" ³⁹ As used in the definition of "underwriter," an "issuer" includes "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." ⁴⁰ Brickell admittedly knew that his customers received stock from issuers as compensation for the customers' promotional activities. He also knew that they intended to use their World Trade accounts to liquidate the stock. Notwithstanding these facts, Brickell failed to ask whether his customers received their shares from iStorage, the issuer, or from a control person of the company. The record shows that, had Brickell done so, he would have learned that the customers obtained their shares from the 12.5% Shareholders, whose ownership interest in iStorage and coordinated sales of a large block of its stock a week after the reverse merger were strong indicia that they controlled iStorage and their sales of iStorage shares were part of an unregistered distribution. ⁴¹

We reject World Trade and Brickell's argument that they met their statutory burden under Section 4(4) by establishing that their transactions were "unsolicited." To the contrary, determining whether a transaction is an "ordinary brokerage transaction" under Section 4(4) requires more than examining whether solicitation was used. We have long recognized that unregistered sales of large blocks of securities by brokers "without [the use of] solicitations or other sales activities" may nonetheless violate the registration requirements. ⁴² As we have repeatedly held, a "broker relying on Section 4(4) cannot merely act as an order taker, but must

³⁹ 15 U.S.C. § 77b(a)(11).

⁴⁰ *Id.*; see also *Pennaluna*, 410 F.2d at 864 n.1 ("If any person buys from a controlling person with a view to redistribution . . . , this becomes a transaction by an underwriter which requires registration.").

⁴¹ See 17 C.F.R. § 230.405 (defining "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise"); *Cavanaugh*, 445 F.3d at 113 n.19 ("Although there is no bright-line rule declaring how much stock ownership constitutes 'control' . . . , some commentators have suggested that ownership of something *between ten and twenty percent* is enough, especially if other factors suggest actual control. Here, the four partners sold their shares as a block" (emphasis added and citation omitted)).

⁴² *Haupt & Co.*, 23 S.E.C. at 605 & nn. 25-26; *Quinn & Co.*, 44 S.E.C. at 467.

make whatever inquiries are necessary under the circumstances to determine that the transaction is only a normal 'brokers' transaction' and not part of an unlawful distribution."⁴³

Applicants also incorrectly state that FINRA was required to prove that World Trade and Brickell's sales in fact involved an underwriter but that FINRA failed to do so. Applicants assert that FINRA did not produce any evidence showing how the 12.5% Shareholders "acquired their shares, whether they were in fact control persons of iStorage . . . , and whether any exemption was ultimately available to them in their sales to the firm's customers." Applicants' position wrongly shifts the burden of establishing an exemption to FINRA. Once FINRA proved a *prima facie* Section 5 violation, it became Applicants' burden to show that Section 4(4) exemption applied by, among other things, showing they conducted a reasonable inquiry.⁴⁴ Indeed, the questions that Applicants claim FINRA failed to answer during the proceeding were some of the questions that Applicants should have asked their customers upon their request to sell a large block of an obscure security without registration.⁴⁵ Although Applicants claim that they had "no power . . . to compel [such] information" from their customers or others (such as iStorage and the 12.5% Shareholders), they made no attempt to gather relevant information. If Applicants had attempted to do so and were denied, they could have declined to sell the stock for the customers.

Applicants additionally claim that FINRA was required to prove that Applicants "knew, actually or circumstantially, the facts which indicated an illegal distribution." However, the U.S. Court of Appeals for the D.C. Circuit in *Geiger v. SEC*⁴⁶ rejected a similar argument made by a broker who unknowingly traded shares for a statutory issuer in reliance on the absence of restrictive legends on the stock certificates and the seller's assurances that the stock was "free-trading." The court held the broker's conduct was violative of Securities Section 5 because he "failed to inquire sufficiently into the circumstances of the transaction[.]" given the classic "warning signs that were present" requiring a "searching inquiry."⁴⁷ World Trade's and Brickell's

⁴³ *Leigh*, 50 S.E.C. at 193 (citing the 1962 Securities Act Release, *supra* note 33); *see also Wonsover*, 54 S.E.C. at 15 (rejecting this "truncated view of a broker-dealer's essential duties").

⁴⁴ *See Cavanagh*, 445 F.3d at 111 n.13 (citing *Ralston Purina*, 346 U.S. at 126).

⁴⁵ *Benjamin Werner*, 44 S.E.C. 745, 747 n.5 (1971) (stating that a broker claiming the brokers' exemption, at a minimum, must "question his customer to obtain facts reasonably sufficient under the circumstances to indicate whether the customer is engaged in a distribution").

⁴⁶ 363 F.3d at 485.

⁴⁷ *Id.*; *see also James L. Owsley*, 51 S.E.C. 524, 529 (1993) (sustaining NASD findings of Section 5 violations, notwithstanding representative's claim he "did not know [the illegal distribution] was occurring," because the circumstances presented "the classic pattern of
(continued...)

failure to conduct any inquiry rendered their stock sales similarly violative of the registration requirements.⁴⁸

3. Reliance on Transfer Agent and Industry Standard

Applicants argue, alternatively, that "to the extent that a requirement is implied in the [Section 4(4)] exemption that a broker make some kind of inquiry . . . reliance on transfer agents was commonly accepted practice in the industry." They contend that their reliance on Routh Transfer's removal of restrictive legends from the stock certificates was "logical and cost effective," asserting that "[o]nly the issuer, the shareholder, the transfer agent, and the attorney who gives the opinion to free up the shares . . . are aware of the circumstances under which shares were issued."

It is well established that the willingness of a transfer agent to remove a restrictive legend does not relieve a broker of his obligation to investigate.⁴⁹ Nor does "[t]he absence of a restrictive legend on stock certificates . . . warrant the conclusion that [the shares] must be freely tradeable."⁵⁰ We have emphasized that brokers, "as professionals in the securities business and as persons dealing closely with the investing public, are expected to secure compliance with the

⁴⁷ (...continued)

an unlawful distribution"); *Niebuhr*, 52 S.E.C. at 550-51 (sustaining NASD findings of Section 5 violations, notwithstanding representative's claim he "was not privy to the information about" the stock, because he made no "more than a token inquiry regarding [the stock]'s tradeability").

⁴⁸ We also reject Applicants' contention they lacked sufficient notice of their requirements under the Securities Act. As discussed, we have long regarded a broker's obligation to conduct reasonable inquiry as fundamental. *See e.g., Wonsover*, 54 S.E.C. at 13-14 (quoting, at length, the 1962 Securities Act Release, *supra* note 33). FINRA, too, has issued relevant guidance. *See, e.g.,* NASD Notice to Members 00-49 (cautioning firms about purportedly "free trading" stock of "blank-check companies," a type of development-stage company, and reminding brokers of the "obligation to . . . conduct a meaningful investigation . . . to ensure that it is not engaged in the distribution of an unregistered security").

⁴⁹ *Wonsover*, 205 F.3d at 415 (rejecting the "argument that [broker] justifiably relied on the clearance of sales by [his firm's restrictive stock department], the transfer agent and counsel" (citing, *e.g., Stead v. SEC*, 444 F.2d 713, 716 (10th Cir. 1971) ("[C]alling the transfer agent is obviously not a sufficient inquiry.")). Indeed, we have cautioned that "information received from little-known companies or their officials, transfer agent or counsel must be treated with great caution as these are the very parties that may be seeking to deceive the firm." 1971 Exchange Act Release, *supra* note 33 (citing *SEC v. Culpepper*, 270 F.2d 241, 251 (2d Cir. 1959)).

⁵⁰ *Carley*, 92 SEC Docket at 1713 n.55 (quoting *Tuffli*, 46 S.E.C. at 409).

requirements of the [Securities] Act to protect the public from illegal offerings."⁵¹ Applicants' reliance on Routh Transfer did not reasonably secure such compliance. Even assuming *arguendo* that Routh Transfer acted properly in removing the restrictive legends from the 12.5% Shareholders' stock certificates—relying on the Bertsch Legal Opinion despite, for example, the obvious error in calculating their ownership interest at less than 10%—such action related only to the legality of the reissuance of the Camryn stock certificates without restrictive legends to the 12.5% Shareholders, not to subsequent transactions of iStorage stock, such as Brickell's sales for his customers.⁵² Applicants, moreover, concede that Routh Transfer did not consider itself responsible for conducting any due diligence on Applicants' behalf, and there was no evidence it conducted the necessary inquiry.

Applicants also have not established their claim that reliance on the transfer agent "was widely, if not universally, the practice in the brokerage industry." Applicants' broad assertion is based on testimony from fact witnesses at FINRA's hearing. All but one of these witnesses were employees of member firms that were charged with registration violations—including World Trade's Brickell, Michel, and Adams and those employed by another firm that sold iStorage shares.⁵³ Such testimony is not evidence of an industry-wide standard, only that the practice was widespread at these particular firms. Applicants neither introduced expert testimony nor do they cite any authority to support their claim of a widespread industry practice. Applicants additionally cite testimony given by a FINRA examiner. However, the examiner testified as a fact witness, not an expert witness. Moreover, the examiner testified only that he could not confirm the "custom and practice in the industry" because he "[hadn't] surveilled the entire industry."

In any event, we note, as courts have held, compliance with the industry standard is only one factor, not the controlling factor, to be weighed in determining the standard of care for a particular regulation.⁵⁴ In our view, given the long-standing requirement of a broker under the

⁵¹ *Butcher*, 48 S.E.C. at 643 (quoting *Quinn & Co.*, 452 F.2d at 946); *Kane v. SEC*, 842 F.2d 194, 198 (8th Cir. 1988) (brokers are uniquely positioned "to ask relevant questions, acquire material information, or disclose [their] findings" regarding an illegal distribution).

⁵² *See e.g., Leigh*, 50 S.E.C. at 194 (broker not entitled to rely on "counsel[']s letter] . . . to the transfer agent" because it "dealt only with the legality of reissuing the . . . shares to [sellers], not with the legality of sales by those persons."); *Owsley*, 51 S.E.C. at 530 n.21 (broker could not "reasonably rely on an attorney who was acting for the individual making the distribution in question").

⁵³ *See supra* note 2.

⁵⁴ *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004) (citing *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 857 (9th Cir. 2001) ("The industry standard is a relevant
(continued...)

Section 4(4) exemption to conduct a reasonable inquiry before engaging in unregistered sales of securities, the applicable standard of care was clear.⁵⁵

Accordingly, we find that World Trade and Brickell failed to meet their burden of establishing that their unregistered sales of iStorage stock qualified for the Section 4(4) exemption and therefore conclude that they violated Securities Act Section 5 and Rule 2110.⁵⁶

B. Supervisory Failings

"Assuring proper supervision is a critical component of broker-dealer operations."⁵⁷ NASD Rule 3010(a) requires member firms to "establish and maintain" a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." To ensure compliance with this requirement, "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 the securities laws."⁵⁸

NASD Rule 3010(b) further requires member firms to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives . . . that are reasonably designed to achieve compliance

⁵⁴ (...continued)

factor, but the controlling standard remains one of reasonable prudence."); *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 274 (3d Cir. 1998) (noting that "a universal industry practice may still be fraudulent").

⁵⁵ *Wonsover*, 205 F.3d at 415 (stating that the 1962 Securities Act Release's "oft-quoted paragraph," discussed *supra* note 33 and accompanying text, "clarifies when a broker's inquiry can be considered reasonable").

⁵⁶ A violation of Securities Act Section 5 also violates NASD Rule 2110. *Sorrell*, 679 F.2d at 1326 ("such an obvious violation of the securities laws also" violates FINRA's rule requiring members to observe high standards of commercial honor and just and equitable principles of trade).

⁵⁷ *Ronald Pellegrino*, Exchange Act Rel. No. 59125 (Dec. 19, 2008), 94 SEC Docket 12628, 12641.

⁵⁸ *John B. Busacca, III*, Exchange Act Rel. No. 63312 (Nov. 12, 2010), 99 SEC Docket 34481, 34495-96 (citation omitted), *petition denied*, 2011 U.S. App. LEXIS 25933 (11th Cir. Dec. 28, 2011); *see also George J. Kolar*, 55 S.E.C. 1009, 1016 (2002) (stating that "[d]ecisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations").

with applicable . . . rules of NASD." With respect to the registration provisions of the Securities Act, we have emphasized that "all registered broker-dealers should establish minimum standard procedures to prevent and detect violations of the federal securities laws and to ensure that the firm meets its continuing responsibility to know both its customers and the securities being sold."⁵⁹ These procedures must be made known to firm personnel "and be sufficient to reveal promptly to supervisory officials transactions which may, when examined individually or in the aggregate, indicate that sales in a security should be halted immediately" for violations of the Securities Act.⁶⁰

There is no dispute that Michel and Adams shared responsibility for supervising the Firm's registered representatives' trading activities, as World Trade's Supervisory Manual and their testimony confirmed their authority. Michel also admitted that, as World Trade's president, he was responsible for developing the Firm's written procedures that were in effect.

We agree with FINRA that Michel, Adams, and World Trade⁶¹ "ignored key 'red flags' that should have prompted them to investigate whether [Brickell] . . . [was] participating in an unlawful distribution." Adams, the day-to-day supervisor, admittedly knew that Brickell was selling large blocks of recently issued shares of a little-known penny stock, without registration, for customers with known ties to stock promotion. Michel, like Adams, reviewed the Firm's trade blotters and customer account statements and monitored Brickell, and had he properly done so, he would have found that Brickell's iStorage sales met the classic warning signs of an unregistered distribution. Such red flags required both supervisors to respond promptly and decisively by investigating whether Brickell's sales complied with the registration requirements.⁶²

⁵⁹ *A.G. Becker Paribas Inc.*, 48 S.E.C. 118, 120-21 (Feb. 19, 1985) (settled proceeding) (quoting the 1971 Exchange Act Release, *supra* note 33); L. Loss & J. Seligman, *Fundamentals of Securities Regulation* 427 (4th ed. 2004).

⁶⁰ 1971 Exchange Act Release, *supra* note 33.

⁶¹ A violation by a firm's supervisors of their duty to supervise may be imputed to the firm. *See, e.g., CE Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988).

⁶² *Owsley*, 51 S.E.C. at 535 (finding firm president and compliance officer failed to supervise under NASD rules where they "were aware that vast amounts of the securities of two small and unseasoned companies were being sold" but "made no independent investigation . . . [into] the registration status of those securities"); *cf. Merrill, Lynch, Pierce, Fenner, & Smith, Inc.*, 45 S.E.C. 185, 189 (1972) (finding branch manager failed to supervise under the Exchange Act, where he was aware of facts strongly suggesting customer was a statutory underwriter but "made no further inquiries and did not 'find an exemption' under the Securities Act for [the unregistered] sales").

Neither supervisor conducted any investigation into Brickell's sales, nor did they require registered representatives to conduct any inquiry into the stock they sold for customers. We regard such failures as symptomatic of a supervisory system that was not reasonably designed to achieve compliance with the securities laws. Adams himself believed that a stock certificate without a restrictive legend meant the shares were automatically "free trading." Michel agreed, asserting that the Firm had no independent responsibility to look into the circumstances of stock it was asked to sell for customers. As noted above, however, a broker-dealer has the primary responsibility to prevent illegal sales of securities from taking place and supervisors "may no more ignore the obvious need for further inquiry . . . than may a salesperson."⁶³

World Trade's written procedures were also deficient. While a large portion of World Trade's business comprised unregistered stock sales on the Pink Sheets, the Firm's procedures were poorly designed to supervise this type of business and were not reasonably designed to deter or detect misconduct. The Supervisory Manual lacked meaningful guidance setting forth "reasonable inquiry" procedures for registered representatives to follow when customers sought to sell large amounts of an unknown stock to the public without registration. Although World Trade had minimal procedures in place for selling "control" or "restricted" stock, these procedures, as the supervisors testified, assumed that such stock could be easily identified by checking whether the stock certificate bore a restrictive legend—a process that, as discussed, neither ensures that securities are being lawfully sold nor comports with a broker's responsibility in transacting business in the securities industry.

It is particularly critical that a firm, such as World Trade, that devotes a significant portion of its business to the unregistered sale of securities have adequate procedures instructing its sales staff how to identify an unlawful distribution.⁶⁴ The written procedures, as Applicants admitted, included no specific risk factors alerting sales personnel to the possibility that a proposed transaction might be part of an unlawful distribution, including the classic warning signs of an obscure issuer, a thinly traded security, and the deposit of stock certificates in a large volume of shares. The procedures also lacked any meaningful guidance to sales personnel to determine whether a proposed sale is exempt from registration,⁶⁵ such as basic questions to ask

⁶³ *Carley*, 92 SEC Docket at 1722 (citing *Sorrell*, 679 F.2d at 1327).

⁶⁴ *See, e.g., Gary E. Bryant*, 51 S.E.C. 463, 471 (1993) (holding that a mere list of procedures listing "things that the firm and its representatives should not do" is insufficient to establish a reasonable supervisory system but must include "mechanisms for ensuring compliance"); *Steven P. Sanders*, 53 S.E.C. 889, 900 (1998) (finding firm's procedures inadequate where compliance manual correctly stated the rule but gave no meaningful guidance about how to comply with it).

⁶⁵ For example, while the procedures required staff to sell "144 Stock" in a "broker transaction" and to obtain "the necessary documentation" before selling the stock, the procedures
(continued...)

their customers, including how, when, and under what circumstances the customer acquired the stock, as well as background information regarding the issuer.⁶⁶ As a result of these deficiencies, the Firm's written procedures also failed to provide the supervisors with a reliable mechanism for flagging unregistered sales of securities that should be investigated or halted for violating the Securities Act.⁶⁷

Applicants do not deny that their written procedures failed to contain such guidance but assert that the Supervisory Manual "was subject to routine examination by FINRA," and "there is no complaint by FINRA in connection with any examination about the [Firm's] procedures," which they claim is further evidence they followed the industry standard. Applicants have offered no evidence regarding FINRA's previous responses to these specific procedures and, in any event, we have long rejected similar attempts to shift regulatory compliance to FINRA.⁶⁸ Moreover, we do not view the Firm's failure to have relevant procedures in its Supervisory Manual as sufficient to establish an industry-wide standard.⁶⁹

Accordingly, we find that World Trade, Michel, and Adams violated NASD Rules 3010(a) and 2110 by failing to supervise Brickell with a view to ensuring compliance with the Securities Act and NASD rules. We further find that World Trade and Michel violated NASD Rules 3010(b) and 2110 by failing to establish adequate procedures to ensure compliance with applicable requirements.

⁶⁵ (...continued)
failed to define those terms.

⁶⁶ "Basic information concerning the issuer such as its address, business activities, principals, products, assets, financial condition and number of shares of stock outstanding, should be obtained independently as a matter of course." 1971 Exchange Act Release, *supra* note 33.

⁶⁷ *See, e.g., La Jolla Capital Corp.*, 54 S.E.C. 275, 282 (1999) (finding firm's procedures deficient, where the manual identified a prohibited practice, "but it did not set forth any specific procedures that the branch manager should use to detect or prevent those practices").

⁶⁸ *See, e.g., CMG Inst'l Trading, LLC*, Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802, 13813 n.33; *Owsley*, 51 S.E.C. at 534 n.27; *Don D. Anderson & Co.*, 43 S.E.C. 989, 991 (1961), *aff'd*, 423 F.2d 813 (10th Cir. 1970).

⁶⁹ *See supra* notes 52-54 and accompanying text.

IV.

Under Exchange Act Section 19(e)(2), we sustain sanctions imposed by FINRA unless we find, giving "due regard for the public interest and the protection of investors," the sanctions are "excessive or oppressive" or impose an unnecessary or inappropriate burden on competition.⁷⁰ For unlawfully selling securities without registration, FINRA fined World Trade and Brickell each \$15,000 and imposed against Brickell a thirty-day suspension. For failing to supervise Brickell and having deficient written procedures, FINRA aggregated its sanctions against World Trade and Michel, fining each \$30,000 and suspending Michel for forty-five days. For failing to supervise, FINRA fined Adams \$20,000 and suspended him for thirty days.

The imposed sanctions are consistent with FINRA's Sanction Guidelines.⁷¹ For the unregistered sale of securities, the Guidelines recommend a fine between \$2,500 and \$50,000, (plus any financial benefit Applicants may have derived) and, in egregious cases, a suspension of the individual for up to two years or a bar. For failing to supervise, the Guidelines recommend a fine between \$5,000 and \$50,000 and a suspension up to 30 business days, and, in egregious cases, a bar. For having deficient written procedures, the Guidelines recommend a fine of \$1,000 to \$25,000, and, in egregious cases, a suspension of the responsible individual for up to one year and the firm for thirty days and thereafter until the procedures are amended to conform to rule requirements.

We agree with FINRA that World Trade and Brickell's unlawful sales were egregious. The "essential purpose of the 1933 Act is to protect investors by requiring registration with the Commission of certain information concerning securities offered for sale."⁷² Broker-dealers, in occupying a "cardinal role . . . in the securities distribution process," must "take all reasonable steps to avoid participation in distributions violative of [the registration provisions]."⁷³ The relevant FINRA Guidelines direct adjudicators to consider whether Applicants "attempted to comply with an exemption from registration" and "the share volume and dollar amount of the transactions involved." World Trade and Brickell, however, failed to make any reasonable effort

⁷⁰ 15 U.S.C. § 78s(e)(2). Applicants do not claim, nor does the record show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

⁷¹ We are "not bound by the Guidelines [but] use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2)." *CMG*, 95 SEC Docket at 13814 n.38.

⁷² *Gilligan, Will & Co.*, 267 F.2d 461, 463 (2d Cir. 1959); *see also Kirby*, 56 S.E.C. at 72 ("The registration requirements are the heart of the securities regulatory system.").

⁷³ *Wonsover*, 54 S.E.C. at 17 (internal alteration and quotation omitted) (quoting *L.A. Frances, Ltd*, 44 S.E.C. 588, 593 (1971)); *see also Apex Fin. Corp.*, 47 S.E.C. 265, 269 (1980) (noting broker-dealers' responsibility "to prevent their firms from being used as conduits for illegal distributions").

to comply with the Section 4(4) exemption, making no inquiry of their customers before selling the iStorage stock without registration. Their sale of 2.3 million shares of iStorage was substantial and yielded approximately \$295,000 in sales proceeds over a three-month period. World Trade and Brickell's claimed reliance on the transfer agent to conduct due diligence on their customers' sales showed a lack of understanding of a critical duty of a securities professional.⁷⁴ On these grounds, we find the sanctions FINRA imposed were warranted, as they fall within the middle range of the sanctions recommended.⁷⁵

The conduct of World Trade's supervisors was similarly unacceptable. "Proper supervision is the touchstone to ensuring that broker-dealer operations comply with the securities laws and NASD rules" and a "critical component to ensuring investor protection."⁷⁶ The Guidelines call for consideration of whether Applicants "ignored 'red flag' warnings that should have resulted in additional supervisory scrutiny." Both supervisors possessed information that should have prompted their investigation into whether Brickell's iStorage sales were part of a public distribution, such as indications that the sales involved a little-known issuer, recently issued shares, a large volume of shares, and sellers known to work for a stock promoter. The supervisors, however, ignored the obvious need for inquiry, and their erroneous assumption that the Firm had no duty to investigate stock it sold for customers contributed substantially to the Firm's deficient supervisory system.

The Guidelines further instruct adjudicators to consider whether deficient supervisory written procedures "allowed violative conduct to occur or to escape detection." As FINRA stated, World Trade had "no procedures to keep . . . [the] firm compliant with Section 5's registration requirements or to direct the firm's representatives to the proper way to avoid unlawful distributions." FINRA found the absence of such procedures aggravating given that "75 percent" of World Trade's business involved unregistered sales of securities. World Trade's written supervisory procedures also gave the Firm's sales personnel no meaningful guidance on

⁷⁴ *Culpepper*, 270 F.2d at 251 (finding broker's "sole reliance on the self-serving statements of his sellers and their counsel without reasonably exploring the possibility of contrary facts demonstrate . . . a behavior which at best was unconcerned with compliance with the [Securities] Act").

⁷⁵ We note that Exchange Act Section 19(e)(2) "permits us to 'cancel, reduce, or require the remission of' a sanction imposed by a self-regulatory organization, but does not permit us to increase the sanction." *Gregory W. Gray, Jr.*, Exchange Act Rel. No. 60361 (July 22, 2009), 96 SEC Docket 19038, 19055 n.41. Although the applicable Guidelines authorized FINRA to include as part of the fine imposed any remuneration Applicants received for selling iStorage shares, it declined to do so.

⁷⁶ *Dennis S. Kaminski*, Exchange Act Rel. 65347 (Sept. 16, 2011), ___ SEC Docket ___, ___ (collecting cases).

determining whether a given sale was exempt from registration.⁷⁷ Rather, as FINRA found, the Firm left all "responsibility for compliance with the Securities Act" to third parties, such as transfer agents and clearing firms, denying it had any responsibility of its own.

Applicants claim the sanctions "are excessive and punitive in light of the circumstances." In support, they again assert that their conduct conformed with industry practice and therefore cannot be egregious or intentional. As discussed above, Applicants failed to prove a prevailing industry practice. Moreover, we agree with FINRA that Applicants' failure to conduct any inquiry or to ensure compliance with Securities Act Section 5 was at least reckless, particularly given the numerous red flags raised by the stock and that most of the Firm's trading business involved the unregistered sale of securities.⁷⁸

Applicants further argue that FINRA's sanctions were punitive, not remedial, because FINRA refused to "stagger" the suspensions against Michel, Adams, and Brickell, a decision which Applicants state will result in the Firm having no principals "for a period of 6 weeks."⁷⁹ Applicants assert that this "w[ill] prevent the[ir] customers from executing transactions for an extended period" and "[e]ffectively . . . put[] the firm out of business." Applicants contend that their argument is consistent with the General Principles of FINRA's Sanction Guidelines, which recommend the consideration of a firm's size and available resources to ensure that a sanction is remedial, not punitive.

Since at least May 12, 2009, when Michel, Adams, and Brickell were first suspended by the Hearing Panel, the Firm has been aware of the possibility that all three individuals would be suspended concurrently, and not consecutively. The Firm thus "had ample opportunity to take steps to provide for interim managerial and supervisory arrangements" to ensure that management responsibilities would be carried out by properly registered principals, but took no

⁷⁷ The supervisors indicated that, since FINRA commenced this action, the Firm has begun "on a trial basis" using customer questionnaires before selling "unlegended" stock for customers. Such a questionnaire was not admitted into evidence and there was no other indication that the Firm has taken corrective measures. FINRA included among its sanctions an undertaking that World Trade subject its procedures to review by an independent consultant, approved by FINRA.

⁷⁸ See *McCurdy v. SEC*, 396 F.3d 1258, 1264 (D.C. Cir. 2005). Nor does Applicants' ignorance of their duty to conduct reasonable inquiry serve to mitigate their nonfeasance. *Prime Investors, Inc.*, 53 S.E.C. 1, 5 (1997) (holding that "ignorance of the regulations at issue affords no excuse").

⁷⁹ Since the conduct at issue occurred, World Trade has promoted Brickell to chief compliance officer. See *supra* note 6.

action.⁸⁰ Moreover, an otherwise remedial sanction does not become punitive simply because its imposition might cause some harm to a small firm. Rather, such harm is one factor, among others, to consider as part of the overall remedial inquiry.⁸¹ The fact that the three principals who committed these violations are World Trade's only principals does not outweigh the public interest in protecting investors from recurrence of similar violations of the registration requirements. All three principals consistently testified that they have no responsibility to protect the public against illegal distributions.

Applicants cite three instances in which FINRA has imposed suspensions of the principals consecutively. The appropriate sanction, however, depends on the facts and circumstances of each case and cannot be precisely determined by comparison with action taken in other proceedings.⁸² Applicants also assert that they "have been operating World Trade without further problems in the area of unlegended securities for the last 7 years." We have repeatedly stated that a "lack of disciplinary history is not a mitigating factor" because "firms and their associated persons should not be rewarded for acting in accordance with their duties."⁸³

Accordingly, we find that the sanctions FINRA imposed were neither excessive nor oppressive but remedial. Applicants' failure to discharge their duties as securities professionals caused 2.3 million shares of an unknown stock to be sold to investors without registration or exemption therefrom, depriving investors of the protections afforded by the registration and disclosure requirements of the Securities Act. As we have stressed, "[t]he importance of broker-dealer's responsibility to use diligence where there are any unusual factors is highlighted by the fact that violations of the antifraud and other provisions of the securities laws frequently depend for their consummation . . . on the activities of broker-dealers who fail to make diligent

⁸⁰ *Bruns, Nordeman & Co.*, 40 S.E.C. 652, 664 (1961) (rejecting request of settling respondents for "consecutive rather than concurrent [suspensions] in order that both of the senior partners will not be absent from the firm at the same time"); *accord Hans N. Beerbaum*, Exchange Act Rel. No. 55731 (May 9, 2007), 90 SEC Docket 1863, 1871 & n.22 ("[O]nce Beerbaum was suspended, it was Applicants' obligation to cause management responsibilities to be carried out by a properly registered principal.").

⁸¹ *Beerbaum*, 90 SEC Docket at 1871-72 & n.22 (rejecting argument by firm's president and sole owner who claimed barring him would cause him "great economic hardship" and "unfair" punishment because, effectively, "[he] is the Firm"); *see also Ashton Noshir Gowadia*, 53 S.E.C. 786, 793 (1998) (stating that "economic harm alone is not enough to make the sanctions imposed . . . by [FINRA] excessive or oppressive").

⁸² *Butz v. Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182, 187 (1973).

⁸³ *CMG*, 95 SEC Docket at 13816 (quoting *Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006) (internal quotation marks and alteration omitted)).

inquiry to obtain sufficient information to justify their activity in the security."⁸⁴ In addition, the sanctions imposed serve both general and specific deterrence, encouraging these Applicants, as well as others in the industry, to ensure that they comply with the requirements of Section 5 of the Securities Act when conducting transactions on behalf of their customers.⁸⁵

An appropriate order will issue.⁸⁶

By the Commission (Commissioners WALTER, PAREDES, and GALLAGHER);
Chairman SCHAPIRO and Commissioner AGUILAR not participating.

Elizabeth M. Murphy
Secretary

⁸⁴ *Transactions in the Securities of Laser Arms Corp. by Certain Broker-Dealers*, 50 S.E.C. 489, 506 n.35 (1991) (Exchange Act 21(a) report) (quoting *Alessandrini & Co.*, 45 S.E.C. 399, 406 (1973)).

⁸⁵ *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005) ("[G]eneral deterrence is not, by itself, sufficient justification for expulsion or suspension . . . [but] may be considered as part of the overall remedial inquiry.").

⁸⁶ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Rel. No. 66114 / January 6, 2012

Admin. Proc. File No. 3-14307

In the Matter of the Application of

WORLD TRADE FINANCIAL CORP.,
JASON TROY ADAMS, FRANK EDWARD
BRICKELL, and RODNEY PRESTON MICHEL
c/o John Courtade, Esq.
Law Office of John Courtade
4408 Spicewood Springs Road
Austin, TX 78759

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action, and the costs imposed, by FINRA against World Trade Financial Corp., Jason Troy Adams, Frank Edward Brickell, and Rodney Preston Michel, be, and they hereby are, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary