SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 66200 / January 20, 2012

Admin. Proc. File No. 3-14308

In the Matter of the Application of

MIDAS SECURITIES, LLC, and JAY S. LEE
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**

Former member firm of registered securities association engaged in the unregistered sale of securities in violation of Securities Act and association's rules and failed, together with its president, to maintain adequate written supervisory procedures and exercise reasonable supervision over the firm's registered representatives engaging in unregistered sales. *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 *Midas Securities, LLC,* and *Jay S. Lee*.

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

Appeal filed: March 24, 2011
Last brief received: July 27, 2011

**I.**

Midas Securities, LLC ("Midas Securities" or the "Firm"), formerly a FINRA member firm,[1] and Jay S. Lee (collectively, the "Applicants"), Midas's president and chief executive officer, appeal from a FINRA disciplinary action.[2] FINRA found that Midas violated Section 5 of the Securities Act of 1933 and NASD Conduct Rule 2110 by unlawfully selling securities without a registration statement in effect or an available exemption. In connection with these sales, FINRA also found that Applicants violated NASD Conduct Rules 3010 and 2110 by failing to maintain adequate written supervisory procedures and to supervise reasonably Firm registered representatives who engaged in the unregistered sales.[3] FINRA fined Midas $80,000, fined Lee $50,000, suspended Lee in all principal capacities for two years, and assessed costs.[4] We base our findings on an independent review of the record.

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[1] Midas voluntarily withdrew its FINRA membership, effective January 12, 2010.

[2] 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 with NYSE Regulation, Inc. *See* Securities Exchange Act Rel. No. 56148 (July 26, 2007), 91 SEC Docket 522. Because this disciplinary action was instituted after consolidation, references to FINRA herein include references to NASD.

[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 64-67 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."

[4] 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. World Trade Financial Corp. and three associated persons also appealed from the underlying FINRA decision, which is the subject of a separate Commission opinion in *World Trade Financial Corp.*, Exchange Act Rel. No. 66114 (Jan. 6, 2012), __ SEC Docket __.

## II.

Many of the core facts are not in dispute.[5] During the period from December 20, 2004, to February 11, 2005, Midas sold 760,000 shares of a thinly traded penny stock, iStorage, Inc. ("iStorage"), for Petar D. Mihaylov ("Mihaylov"), who held an account at Midas. iStorage's securities traded in the over-the-counter market and were quoted on the "Pink Sheets."[6] Midas registered representatives Benjamin Centeno and Jeffrey Santohigashi admitted that they sold the stock for Mihaylov.[7] None of the transactions was registered with the Commission.

### A. Background

Beginning in 1999, Midas was a registered broker-dealer located in Anaheim, California. Midas's business consisted primarily of providing direct market access to the U.S. securities markets for orders originating in Korea. Lee joined Midas in 2002 and was its president, CEO, chief compliance officer ("CCO"), chief supervisory officer ("CSO"), and Financial and Operations Principal ("FINOP").

In 2003, Lee expanded Midas's business to retail brokerage by hiring several salespersons from Equitrade Securities Corp. ("Equitrade"), which was closing. Midas's new sales staff included Centeno and Santohigashi, who specialized exclusively in purchasing and selling securities for customers in the over-the-counter market. Centeno and Santohigashi had limited securities experience: Centeno testified that he formerly worked as a part-time employee at Equitrade and had been a registered representative since 2001; Santohigashi testified that he worked as a clerk in Equitrade's back office and did not become a registered representative until June 2003, after joining Midas.

Mihaylov opened his Midas account in December 2003. As part of his account application, Mihaylov represented that he was a Bulgarian national, residing in Pazardjik, Bulgaria, employed as a "web designer," and interested in investing in "long-term growth." However, several of Mihaylov's initial representations were inaccurate. The registered

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[5] The parties stipulated to many facts relating to the unregistered sales 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.").

[6] 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 Pink Sheets had no listing requirements for companies whose securities were quoted on its system.

[7] FINRA also charged Centeno and Santohigashi. Before commencement of FINRA's hearing, both consented, without admitting or denying the allegations, to an order finding their iStorage sales were violative of Securities Act Section 5, fining each $10,000, and suspending Centeno and Santohigashi in all capacities for thirty and twenty days, respectively.

representatives testified that they later learned that Mihaylov was a stock promoter for penny stock companies and was interested exclusively in selling stock that he held in the short term. Santohigashi testified that, after opening his account, Mihaylov did "quite a bit of business" liquidating large blocks—typically "500,000 to a million shares"—of "Bulletin Board and Pink Sheet securities."[8]

By March 2004, Centeno helped negotiate a Finder's Agreement between Midas and Mihaylov. Under the agreement, Midas referred companies to Mihaylov for him to promote. In turn, Mihaylov paid Midas 10% of any cash or stock he received from the companies that Midas had referred. Both registered representatives testified that Lee was aware of the Finder's Agreement and accepted Mihaylov's referral fees—often in stock of the company that Mihaylov promoted—on behalf of the Firm.

**B. Midas's Policies and Procedures on Selling Restricted Securities**

Lee testified that he was responsible for ensuring that the Firm's practices and procedures were "correct, full, and complete." Midas's Supervisory Procedures Manual (the "Supervisory Manual") set forth written procedures applicable to the sale of "restricted securities," which it defined to include "[s]ecurities that are acquired directly or indirectly from the issuer or from an affiliate of the issuer, in a transaction not involving any public offering." According to the Supervisory Manual, Midas's registered representatives were required to conduct "[a]ll restricted securities transactions" in accordance with Securities Act Rule 144 and to contact Lee, as CSO, for his approval "[b]efore conducting a restricted security transaction."[9]

Firm personnel testified that, in practice, the Firm identified restricted securities by inspecting whether the stock certificate deposited at the Firm bore a restrictive legend against the resale of the security.[10] According to Centeno, a stock certificate that lacked a restrictive legend was "free trading" and "we would [then] send it to the clearing firm," which in consultation with iStorage's transfer agent, would reissue the stock in "street name" to be resold to the public.

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[8] In July 15, 2008, in an unrelated proceeding, the Commission filed a civil complaint against Mihaylov alleging he "carried out a $32 million pump-and-dump fraud scheme," involving "so-called 'free trading' stock" of another penny stock company. The case, which alleges, among other things, that Mihaylov used a "spam e-mail campaign" to orchestrate the fraud, remains pending. *SEC v. Homeland Safety Int'l, Inc.*, 3-08CV1197-0 (filed July 15, 2008, N.D. Tx.).

[9] 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.

[10] 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, 487 (D.C. Cir. 2004).

Santohigashi agreed, stating that, "once it came back from the transfer agent as free trading, that is the point at which it would be okay to sell it."[11]

**C. Applicants' Prior FINRA Disciplinary Action**

On November 10, 2004, just prior to the conduct at issue, Midas and Lee executed a letter of Acceptance, Waiver and Consent ("AWC") to settle FINRA disciplinary action involving the sale of restricted securities. The AWC stated that FINRA charged Applicants with violating Securities Act Section 5 and NASD Rule 2110 by selling 125,000 shares of Midas's parent company, Midastrade.com, Inc., without a registration statement in effect or an available exemption. According to the AWC, although "there was no trading restriction legend" on the stock certificate, the shares were restricted from resale. The AWC further stated that Lee had "authorized these sales" on behalf of the Firm.

In a corrective action statement accompanying the AWC, Lee assured FINRA that "the [F]irm is committed to not let an incident like this happen again." He represented that Midas had "done a thorough review of procedures for the acceptance of restricted and Rule 144 securities" and would "obtain an expert opinion such as outside legal counsel when it is unclear if securities are unregistered or registered." On December 27, 2004, FINRA accepted the AWC, censured and fined them $10,000. As part of the agreement, the AWC stated that "[t]he AWC will become part of [Applicants'] permanent disciplinary record and may be considered in any future actions brought by [FINRA]."[12]

**D. 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

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[11] William Cantrell, another Midas employee, discussed *infra* in text following note 24, testified that it was the Firm's practice to assume that a stock certificate that lacked a restrictive legend was freely tradable, requiring no investigation of the stock before selling it in the market.

[12] The AWC and Lee's corrective action statement were admitted into evidence. Applicants also stipulated to many of the facts contained in those documents.

company, that had been in operation since May 28, 2004.[13] The resulting entity of the reverse merger was renamed iStorage.[14]

There was limited information available about iStorage on the Pink Sheets Web site at the time Midas 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,[15] 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

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[13] 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).

[14] *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).

[15] 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.

that, under Securities Act Rule 144(k),[16] it believed that the 12.5% Shareholders were not "affiliates" of Camryn.[17]

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. 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 iStorage 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.[18]

In late December 2004, FINRA began investigating possible market manipulation in 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."[19] 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 Pink Sheets. Other press releases followed in rapid succession, announcing that the company had secured several large purchase orders and expanded to global markets.

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[16] 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*, Securities Act Rel. No. 8869 (Dec. 17, 2007), 92 SEC Docket 143, 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.

[17] 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).

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

[19] Emphasis in original.

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.

**E. Midas's Unregistered Sales of 760,000 Shares of iStorage Stock**

Pursuant to a stock purchase agreement, Mihaylov bought 760,000 shares of iStorage stock from one or more of the 12.5% Shareholders on November 4, 2004, at a price of $0.0025 a share, for a total of $1,900.[20] On November 15, 2004, iStorage issued the shares to Mihaylov in a single certificate that did not have a restrictive legend. On November 26, 2004, Mihaylov deposited all 760,000 shares of the recently issued iStorage stock into his Midas account and shortly thereafter requested that they be sold.[21]

Centeno and Santohigashi testified that they knew "nothing" about iStorage at the time of Mihaylov's deposit but conducted no inquiry into the issuer. Moreover, although Mihaylov had deposited a large block of recently issued securities, Centeno and Santohigashi admitted that they did not ask Mihaylov how he acquired the shares, what percentage of iStorage stock he owned, or whether he was associated or affiliated with iStorage. According to their testimony, neither salesman was aware of the existence of Mihaylov's stock purchase agreement with the 12.5% Shareholders until FINRA's hearing in this matter. They also admitted that they took no steps to determine whether the proposed iStorage stock sales were registered with the Commission or qualified for an exemption from registration. Instead, they relied on the fact that Mihaylov's stock certificate bore no restrictive legend against resale.

Upon receipt of Mihaylov's stock, they immediately forwarded it to the clearing firm and transfer agent for processing. Santohigashi, who handled many of Mihaylov's transactions, admitted that he did not contact the transfer agent before selling the stock. As part of Applicants' stipulations, Applicants conceded that neither the transfer agent nor the clearing firm considered itself responsible for conducting any inquiry into the circumstances surrounding a stock sale on

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[20] The stock purchase agreement did not specify whether one or more of the 12.5% Shareholders would contribute shares to the sale to Mihaylov, although iStorage's stock ledger, which was admitted into evidence, indicates that the Mihaylov's stock originated from one of the 12.5% Shareholders.

[21] Mihaylov did not testify at FINRA's hearing. There is no evidence in the record establishing that Midas referred iStorage to Mihaylov, pursuant to the parties' Finder's Agreement. *See supra* text following note 8.

behalf of Midas.[22] Centeno and Santohigashi began selling Mihaylov's iStorage shares over the next two months. The sales yielded $102,000 in proceeds for Mihaylov, which generated approximately $2,200 in sales commissions.

**F. Supervision of Centeno and Santohigashi**

Midas's Supervisory Manual identified Lee as having "overall supervisory responsibilities" and "overall [responsibility for] general compliance with [FINRA] and SEC Rules and Regulations." It also listed Lee and a designated principal—which the Supervisory Manual did not otherwise identify—as responsible for the Firm's "Sales" department and supervision of associated persons. The supervisors' duties included reviewing the daily trade blotters and investigating questionable sales activity by Firm personnel.[23] The Supervisory Manual also specified, as noted, that sales personnel were to contact Lee before selling restricted securities for customers.

Lee testified that, as Midas's president, he was often away from the office, spending up to "two-third[s]" of his time "soliciting business" in Korea. He admitted that he "didn't know" the type of securities business Centeno and Santohigashi conducted until November 2005, after FINRA had begun its investigation into the Firm's iStorage sales. Lee also acknowledged that he did not know the Firm's procedures for determining if stock was restricted from resale or what level of inquiry was required of brokers prior to selling stock without registration. Lee explained that, because he "had no retail experience," he "rel[ied] a lot" on others in the office to supervise the Firm's retail trading, acknowledging that his supervisory style was generally to wait for personnel to come to him with issues.[24]

Lee testified that, during the period at issue, William K. Cantrell ("Cantrell") was the direct supervisor responsible for overseeing the Firm's trading activities and registered representatives. The Firm's Supervisory Manual stated that Cantrell held the title "Manager and Supervisor of Market Making" and listed him, among four other individuals (including Lee), as a "Responsible Supervisor" who oversaw "associated persons." Lee hired Cantrell in June 2004 to replace a former supervisory principal who had left Midas in April 2004. However, Lee

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[22] According to the Firm's clearing agreement, Midas's clearing firm disclaimed any responsibility to conduct "any investigation into the facts surrounding any transaction that it" had with Midas.

[23] In his hearing testimony, Lee claimed that the Supervisory Manual identified another individual as responsible for Sales. However, the Supervisory Manual clearly lists "Sales" under Lee's set of responsibilities, not the other individual's.

[24] According to a FINRA examiner's testimony, Lee told FINRA staff during its investigation that, "if anybody at [Midas] had tried to undertake efforts to determine whether . . . unlegended certificate securities were free trading, he would not have allowed it." Because Lee's on-the-record ("OTR") testimony was not admitted into evidence at FINRA's hearing, we have not considered it, although FINRA and Applicants reference it in their briefs on appeal.

acknowledged that Cantrell's supervisory authority was limited: Cantrell could not hire and fire personnel, incur office expenses, address payroll issues, or grant the registered representatives any time off from work—all of which were handled by Lee. Lee testified that he informed Centeno and Santohigashi shortly after he hired Cantrell that Cantrell was their supervisor.

In his testimony, Cantrell denied having any supervisory responsibility at the Firm. Cantrell stated that he was hired exclusively to help "clean up" the Firm's back-office affairs, which he described as "a mess when [he] got [there]." Although Cantrell acknowledged that he had some prior supervisory experience,[25] he testified that, during his employment negotiations, Lee specifically rejected Cantrell's offer to become a supervisor at Midas, explaining that Lee "didn't want to pay [him]" for the added responsibilities. According to Cantrell, he was supervised by Lee, whom Cantrell described as "supervis[ing] everybody," and the only responsibility that Lee delegated to him was the approval of new account forms because of Lee's extended absences from the office.

Centeno and Santohigashi corroborated Cantrell's testimony, characterizing Cantrell's duties at the Firm as "administrative" and related to back-office operations. Both testified that Lee, not Cantrell, was their direct supervisor, but they explained that neither Lee nor anyone else at the Firm actually supervised their trading activity during the period at issue. As Santohigashi testified, Lee was often "busy doing other . . . things" and out of the office half of the time. Although the registered representatives had limited securities experience, both testified that they did not need any authorization from a supervisor to sell stock from customers' accounts, nor did the Firm place any restrictions on their trading activities.[26] In addition, both Centeno and Santohigashi testified that they were unaware of the Firm's November 2004 AWC regarding the Firm's sale of restricted stock of its parent company.

In their answer to FINRA's charges, Applicants admitted that the Firm had no written procedures addressing when its sales personnel should initiate an inquiry into the registration or exemption status of shares its customers proposed to sell. The Firm's procedures also lacked any guidance about how to determine whether a proposed sale required registration or qualified for an exemption from registration.

## G. FINRA's Proceeding

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[25] According to the Central Registration Depository ("CRD"), which is publicly available at *www.finra.org*, Cantrell entered the securities industry in 1988. In 1997, Cantrell, while a FINOP for another member firm, was fined, censured, and suspended for failing to comply with the net capital requirements. *William K. Cantrell*, 52 S.E.C. 1322 (1997).

[26] Centeno and Santohigashi left Midas in January 2006: Centeno's Form U5 stated that he was "discharged" for "frequent absences," whereas Santohigashi resigned voluntarily, citing in his testimony Midas's financial difficulties as the reason. Cantrell was "discharged" from the Firm in September 2005.

On May 12, 2009, a FINRA Hearing Panel found Midas's unregistered sales of 760,000 iStorage shares for Mihaylov violated Securities Act Section 5 and NASD Rule 2110.[27] The Hearing Panel also found that Midas and Lee violated NASD Rules 3010 and 2110 by failing to adequately supervise Centeno and Santohigashi and by failing "to establish and maintain adequate supervisory procedures to achieve compliance with the requirements of Section 5." The Hearing Panel held that Lee was responsible for the Firm's supervisory failings, finding "Cantrell to be far more credible than Lee on the subject of Cantrell's duties and responsibilities" and rejecting "Lee's claim that Cantrell was [the registered representative's] designated supervisor."

On March 3, 2011, FINRA's National Adjudicatory Council (the "NAC") affirmed the Hearing Panel's findings of liability, including its determination that Lee was responsible for supervising Midas's trading activities. The NAC further upheld the Hearing Panel's imposition of a two-year suspension against Lee as a principal for his failure to supervise and $30,000 fine against Midas for its unregistered sales, but decided to increase the fines assessed against Midas and Lee for their supervisory failures, fining them each $50,000.[28] This appeal followed.

## 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.[29] Section 5(c) of the Securities Act prohibits the "offer for sale" of any securities, unless a registration statement has been filed as to such securities or an exemption is available.[30] The purpose of the registration requirements is to "protect investors by promoting full disclosure of information thought

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[27] Before commencement of FINRA's hearing, Lee consented to findings that he failed to update his Form U4 to reflect his receipt of a FINRA Wells notice regarding the charges in this matter. Lee was suspended forty-five days and fined $15,000.

[28] The NAC also prohibited Midas "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. As noted, Midas has since withdrawn from its membership with FINRA.

[29] 15 U.S.C. § 77e(a).

[30] 15 U.S.C. § 77e(c).

necessary to informed investment decisions."[31] "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 of a new offering by reason of the control of the issuer possessed by those responsible for the offering.'"[32]

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.[33] Scienter—*i.e.*, an intent to deceive—is not a requirement.[34]

Midas concedes that FINRA established a *prima facie* case for violations of Securities Act Sections 5(a) and (c) by showing that its registered representatives, Centeno and Santohigashi, sold iStorage shares, by interstate means, without a registration statement in effect or filed with the Commission.[35]

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[31] *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*").

[32] *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."). 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 hands of the investing public." *Geiger*, 363 F.3d at 487.

[33] *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).

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

[35] Centeno's and Santohigashi's misconduct as Firm registered representatives is imputed to Midas. *See, e.g., CE Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988).

**2. The Section 4(4) Exemption**

Exemptions from the registration requirements are affirmative defenses that must be established by the person claiming the exemption.[36] Registration exemptions "are construed strictly to promote full disclosure of information for the protection of the investing public."[37] Evidence in support of an exemption must be explicit, exact, and not built on conclusory statements.[38]

Midas claims that its 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."[39] 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."[40] Brokers thus have "a duty of inquiry" into the facts surrounding a proposed sale.[41]

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

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[36] *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); *Rodney R. Schoemann*, Securities Act Rel. No. 9076 (Oct. 23, 2009), 97 SEC Docket 21726, 21735, *aff'd*, 398 F. App'x 603 (D.C. Cir. 2010) (unpublished).

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

[38] *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).

[39] 15 U.S.C. § 77d(4).

[40] *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).

[41] *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").

> [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.[42]

A broker, as an agent for its customers, "ha[s] 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."[43]

Here, Midas's customer Mihaylov deposited a large block of recently issued shares of a little-known stock into his account and directed Midas to sell the shares shortly thereafter without a registration statement in effect.[44] Given these circumstances, Midas was required to conduct a searching inquiry to assure itself that Mihaylov's proposed sales were exempt from the registration requirements and not part of an unlawful distribution.[45] However, no one at Midas conducted any inquiry into Mihaylov's proposed sales nor did anyone attempt to gather information about iStorage, the issuer of the stock. Had anyone done so, the information on the Pink Sheets Web site would 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,

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[42] *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 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.").

[43] *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").

[44] *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)).

[45] *See, e.g., Michael A. Niebuhr*, 52 S.E.C. 546, 550 (1995) ("[W]e have long stated [that] 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").

and had a negative balance sheet. By failing to conduct the necessary inquiry, Midas has not met its burden of establishing that the Section 4(4) exemption applied to its iStorage sales.[46]

Mihaylov's known stock promotion activities should have raised additional concerns that his 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 . . . ."[47] 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."[48] Both registered representatives knew that Mihaylov was a stock promoter who received stock from issuers as compensation for promoting their stock and used his Midas account to liquidate those shares. Indeed, Midas received a fee for referring companies to Mihaylov. Notwithstanding these facts, neither registered representative asked Mihaylov, before selling his stock, whether he obtained his block of iStorage shares from the issuer or from a control person at the company. Had the representatives conducted a reasonable inquiry, they would have learned from Mihaylov's stock purchase agreement that he bought his shares from one or more of the 12.5% Shareholders, whose ownership interest of iStorage and coordinated sales of a large block of iStorage stock shortly after the reverse merger were strong indicia that they controlled iStorage and their iStorage stock sales were part of an unregistered distribution.[49]

We reject Midas's argument that it met its statutory burden under Securities Act Section 4(4) by establishing that the transactions were "unsolicited." Contrary to Midas's view, determining whether a transaction is an "ordinary brokerage transaction" under Section 4(4) requires more than examining whether the broker solicited the transaction. We have long recognized that unregistered sales of large blocks of securities by brokers "without [the use of]

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

[47] 15 U.S.C. § 77b(a)(11).

[48] *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.").

[49] *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, 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)).

solicitations or other sales activities" may nonetheless violate the registration requirements.[50] As we have repeatedly held, "[a] broker relying on Section 4(4) cannot merely act as an order taker, but must make whatever inquiries are necessary under the circumstances to determine that the transaction is a normal 'brokers' transaction' and not part of an unlawful distribution."[51]

Midas also contends that FINRA was required to prove that Midas's sales in fact involved an underwriter, but that FINRA failed to do so. Midas asserts that FINRA did not produce any evidence as to 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."

Midas's assertions improperly shift the burden of establishing an exemption to FINRA. Once FINRA proved a *prima facie* Section 5 violation, it was Midas's burden to show that the Section 4(4) exemption applied by, among other things, showing it conducted a reasonable inquiry of the proposed transaction.[52] Indeed, the questions that Midas asserts FINRA failed to answer during the proceeding were some of the questions its registered representatives should have asked Mihaylov upon his request to sell a large block of an obscure stock without registration.[53] Although Midas further claims that it had "no power . . . to compel [such] information"—from Mihaylov or others (such as iStorage and the 12.5% Shareholders)—it made no attempt to gather relevant information. If Midas had attempted to do so and was denied, it could have declined to sell the stock for its customer.

Midas also claims that FINRA was required to prove that Midas's registered representatives "knew, actually or circumstantially, the facts which indicated an illegal distribution." As discussed, Midas was aware of substantial indicia that the proposed iStorage transactions were part of an illegal distribution. Moreover, the U.S. Court of Appeals for the D.C. Circuit in *Geiger v. SEC* [54] rejected a similar argument made by a broker who unknowingly traded shares for a statutory issuer, in reliance on the absence of restrictive legends and the seller's assurances that the stock was "free trading." The court held that the broker, nonetheless, violated Securities Section 5 by "fail[ing] to inquire sufficiently into the circumstances of the

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

[51] *Leigh*, 50 S.E.C. at 193 (citing the 1962 Exchange Act Release and *Kane*, 48 S.E.C. at 621); *see also Wonsover*, 54 S.E.C. at 15 (rejecting this "truncated view of a broker-dealer's essential duties").

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

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

[54] 363 F.3d at 485.

transaction[,]" given the classic "warning signs" requiring a "searching inquiry."[55] Midas's failure to conduct any inquiry rendered its conduct similarly violative of the registration requirements.

**3. Reliance on the Transfer Agent and Clearing Firm**

Midas asserts that to sell Mihaylov's iStorage shares it relied on Routh Transfer in removing the restrictive legend from the iStorage stock and on its clearing firm in processing the shares for resale. However, it is well established that the clearance of sales by a transfer agent and clearing firm does not relieve a broker of its obligation to investigate.[56] As we have emphasized, brokers, "'as professionals in the securities business and as persons dealing closely with the investing public, are expected to secure compliance with the requirements of the [Securities] Act to protect the public from illegal offerings.'"[57] Midas also conceded that neither Routh Transfer nor the clearing firm considered itself responsible for conducting an inquiry for Midas, nor is there evidence that either conducted the necessary inquiry.[58]

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[55] *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 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").

[56] *Leigh*, 50 S.E.C. at 193-94 (collecting cases); *see also Wonsover*, 205 F.3d at 415-16 (rejecting "argument that [broker] justifiably relied on the clearance of sales by [his firm's restrictive stock department], transfer agent and counsel" (citing *A.G. Becker Paribas, Inc.*, 48 S.E.C. 118, 121 (1985) (settled proceeding) ("If a broker relies on others to make the inquiry called for in any particular circumstances, it does so at its peril."")). 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 42 (citing *SEC v. Culpepper*, 270 F.2d 241, 251 (2d Cir. 1959)).

[57] *Butcher & Singer*, 48 S.E.C. at 643 (quoting *Quinn & Co.*, 452 F.2d at 946-47); *see also Kane v. SEC*, 842 F.2d 194, 199 (8th Cir. 1988) (stating that brokers are uniquely positioned "to ask relevant questions, acquire material information, or disclose [their] findings" regarding an illegal distribution).

[58] Moreover, Midas was not entitled to rely on the Bertsch Legal Opinion because it 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. *Leigh*, 50 S.E.C. at 194 (holding that broker could not 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 (holding that broker "could

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The November 2004 AWC, in which Applicants settled charges that they violated Securities Act Section 5, also served as notice that "[t]he absence of a restrictive legend on stock certificates does not 'warrant the conclusion that they must be freely tradeable.'"[59] The AWC included the explicit statement, to which Applicants also stipulated, that the stock Midas had sold for its parent company had "no trading restriction legend" on the stock certificate but was nonetheless restricted from resale. Applicants attempt to distinguish the facts of the AWC by claiming it involved "an inept clerk" selling shares without authorization, not Centeno's and Santohigashi's trading for a customer. However, at a minimum, the AWC alerted Midas to the need to determine whether its unregistered sales of securities complied with Section 5 of the Securities Act, irrespective of whether the stock certificate it received bore a restrictive stock legend.

Equally unpersuasive is Midas's additional claim that reliance on the transfer agent was "widely, if not universally, the practice in the brokerage industry." Midas's broad assertion of industry practice 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 Centeno, Santohigashi, Cantrell, and those employed by another firm that sold iStorage shares.[60] This testimony is evidence only that the practice was widespread at these particular firms, not industry-wide. The only authority Midas cites for its proposition is testimony from 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, 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.[61] In our view, given the long-standing duty of a broker under the Section 4(4) exemption to conduct a

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[58] (...continued)
not reasonably rely on an attorney who was acting for the individual making the distribution in question").

[59] *Carley*, 92 SEC Docket at 1713 n.55 (quoting *Tuffli*, 46 S.E.C. at 409). As noted, the AWC stated that it "may be considered in any future actions brought by [FINRA]."

[60] *See supra* note 4.

[61] *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 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").

reasonable inquiry before selling securities without registration, as well as the notice provided by the AWC, the applicable standard of care was clear for Midas.[62]

Based on the foregoing, we find that Midas has failed to meet its burden of establishing that its unregistered sales of iStorage stock qualified for the Section 4(4) exemption and therefore conclude that it violated Securities Act Section 5 and NASD Rule 2110.[63]

## B. Supervisory Failings

"Assuring proper supervision is a critical component of broker-dealer operations."[64] 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."[65]

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 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

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[62] *Wonsover*, 205 F.3d at 415 (stating that the 1962 Securities Act Release's "oft-quoted paragraph," discussed *supra* in text accompanying note 42, "clarifies when a broker's inquiry can be considered reasonable"). For similar reasons, we reject Applicants' claim that 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. *Leigh*, 50 S.E.C. at 193; *Stone Summers*, 45 S.E.C. at 109. 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").

[63] A violation of Securities Act Section 5 also violates NASD Rule 2110. *Sorrell*, 679 F.2d at 1326.

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

[65] *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) (unpublished); *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").

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."[66] These procedures must be made known to firm personnel and "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 violating the Securities Act.[67]

Midas lacked an adequate supervisory system to deter and detect Centeno's and Santohigashi's unlawful sales of iStorage securities. The record showed that Midas's system of supervision consisted solely of relying on transfer agents and clearing firms to ensure that its unregistered sales complied with the Securities Act, a process that, as described above, neither ensures that stock is lawfully sold, nor comports with a broker's responsibilities. Moreover, the registered representatives who sold the iStorage stock had minimal experience in the securities industry and were relatively new hires to the Firm. We have often stressed the "obvious need to keep [a] new office with . . . untried personnel under close surveillance."[68] Yet the representatives testified that no one at Midas was supervising their sales practices, nor were there any restrictions on their trading activities in the over-the-counter markets.

The registered representatives' sale of a large block of recently issued shares of a little-known, thinly traded stock was ignored by the Firm, despite numerous red flags that the sales were part of an unlawful distribution in violation of Securities Act Section 5. Mihaylov's stock promotion activities were well known at the Firm and Midas received a fee, often in the form of stock, for referring customers to him. These activities, together with Mihaylov's frequent liquidation of large blocks of stocks, should have further alerted supervisors of the need for a reasonable inquiry into his proposed iStorage sales.

Midas's written procedures also inadequately addressed the unregistered sale of securities. Although a significant portion of Midas's business comprised unregistered securities sales in the over-the-counter markets, the Firm's written procedures were poorly designed to deter and detect violations of the Securities Act's registration requirements. The minimal written procedures the Firm had 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.[69] As Applicants admitted, the written

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[66] *A.G. Becker Paribas*, 48 S.E.C. at 120-21 (quoting the 1971 Exchange Act Release, *supra* note 42).

[67] 1971 Exchange Act Release, *supra* note 42.

[68] *LaJolla Capital Corp.*, 54 S.E.C. 275, 282 & n.18 (1999) (internal punctuation omitted) (collecting cases).

[69] *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

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procedures included no specific risk factors alerting registered representatives to the possibility that a proposed transaction might be part of an unlawful distribution—such as 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 guidance to registered representatives about how to determine whether a proposed sale was exempt from registration, including asking their customer how, when, and under what circumstances the customer acquired the stock.[70] Because of these deficiencies, the written procedures also failed to provide the supervisors with a reliable mechanism for identifying securities sales that should be investigated or halted for violating the Securities Act.[71]

Lee does not dispute the fact that he was responsible for the Firm's written supervisory procedures but claims he delegated supervision for the Firm's trading and registered representatives to Cantrell. However, the weight of the evidence does not support a finding that Lee effectively or reasonably delegated his supervisory duties to Cantrell. The Hearing Panel found Cantrell's testimony that he was not the responsible supervisor "was far more credible than Lee['s]." We see no basis for rejecting their conclusion.[72] Both documentary and testimonial evidence corroborates Cantrell's testimony. The Supervisory Manual identified Lee—not Cantrell—as responsible for supervising the Firm's trading department and for approving any restricted securities transactions. Both Centeno and Santohigashi, moreover, testified that they considered Lee to be their supervisor, not Cantrell, and there was no support for Lee's claim that he informed Centeno and Santohigashi that Cantrell was their supervisor. In addition, Lee admitted that Cantrell could not incur office expenses on behalf of the Firm and could not hire,

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[69] (...continued)
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).

[70] *See, e.g.,* 1971 Exchange Act Release, *supra* note 42 (noting that "[b]asic 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" with the level of inquiry increasing based on the circumstances presented).

[71] *See La Jolla*, 54 S.E.C. at 282. We also find no merit to Applicants' claim that Midas's failure to have relevant procedures in its Supervisory Manual was reflective of an industry-wide standard. As discussed, Applicants have not established a prevailing industry practice.

[72] *Anthony Tricarico*, 51 S.E.C. 457, 460 (1993) ("It is well settled that credibility determinations of an initial fact finder are entitled to considerable weight" and "can be overcome only where the record contains 'substantial evidence' for doing so." (citing *Universal Camera v. NLRB*, 340 U.S. 474, 496 (1950)), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000).

fire, or approve the registered representatives' leave from the office—*i.e.,* indications that could otherwise signal Cantrell's supervisory authority over the registered representatives.[73]

Lee cites various circumstantial evidence that he claims shows that Cantrell was the responsible supervisor—such as Cantrell's prior supervisory experience and that he replaced a former supervisor when he was hired in June 2004, was paid like a supervisor, and admittedly performed some supervisory functions while Lee was away from the office. Lee's cited evidence does not refute his failure to effectively delegate supervision by clearly vesting supervisory responsibility in Cantrell for Centeno's and Santohigashi's sales.[74]

Even if we accepted Lee's claim that he delegated line-supervision to Cantrell, Lee, as the Firm's president, retained a duty to follow-up on that delegation, but he failed to do so. We have long held that "'the president of a brokerage firm is responsible for the firm's compliance with all applicable requirements unless . . . he or she reasonably delegated [that] particular function to another person in the firm, and neither 'knew nor had reason to know that such person was not properly performing his or her duties.'"[75] However, "'[i]t is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibilities to a subordinate . . . and then simply wash his hands of the matter until a problem is brought to his attention.'"[76] As we have stated, "[i]mplicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised."[77] The obvious red flags in the registered

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[73] *Richard F. Kresge*, Exchange Act Rel. No. 55988 (June 29, 2007), 90 SEC Docket 3072, 3086 (finding firm's "compliance consultant" was not a supervisor because "no one had a clear understanding of [the consultant]'s responsibilities" and he "had no hiring or firing authority") (citing *Arthur James Huff*, 50 S.E.C. 524, 535 (1991)).

[74] *Kirk A. Knapp*, 50 S.E.C. 858, 862 (1992) (finding president "never made a reasonable or effective delegation" to an employee who denied he was the sales supervisor and "the sales force did not consider [the employee] its supervisor, and was not even aware that he was supposedly functioning in that capacity"); *William E. Parodi*, *Sr.*, Exchange Act Rel. No. 27299 (Sept. 27, 1989), 44 SEC Docket 1337, 1345 (settled proceeding) ("An important factor in the supervisory breakdown was [the firm]'s failure to clearly vest supervisory responsibility.").

[75] *Busacca*, 99 SEC Docket at 34495-96 (quoting *Pellegrino*, 94 SEC Docket at 12641).

[76] *Pellegrino*, 94 SEC Docket at 12647 (quoting *Harry Gliksman*, 54 S.E.C. 471, 484-85 (1999), *aff'd*, 24 F. App'x 702 (9th Cir. 2001) (unpublished)); *Stuart K. Patrick*, 51 S.E.C. 419, 422-23 (1993), *petition denied*, 19 F.3d 66 (2d Cir. 1994).

[77] *Castle Secs. Corp.*, 53 S.E.C. 406, 412 & n.19 (1998) (collecting cases).

representatives' trading, as discussed above, presented Lee with ample notice that supervision in the Firm's retail trading department was not being effectively carried out.[78]

Lee's settlement of the November 2004 AWC served as additional notice. Although Lee assured FINRA at the time that "the [F]irm is committed to not let an incident like this happen again," he exhibited little concern for Centeno's and Santohigashi's unregistered securities sales during the period at issue. Lee admitted that he was often away from the office for long periods of time, "didn't know" of Centeno's and Santohigashi's trading activity until FINRA's investigation, and was unaware of a broker's duty to conduct reasonable inquiry prior to selling stock publicly without registration.

Lee also asserts that FINRA abused its discretion when it excluded from evidence an e-mail that Lee claims proves that Cantrell was charged with supervising the registered representatives. The e-mail, dated June 11, 2004, from Cantrell to Don Carrig, a Midas employee, states that "[C]antrell's Position at Midas Securities, LLC" would involve supervising the "'Trading Desk' and associated persons," including Centeno and Santohigashi. Before FINRA's hearing, FINRA's Hearing Officer precluded Applicants from offering exhibits at the hearing because Applicants had failed to identify any documents in their prehearing submissions that they intended to introduce at the hearing, as previously required by the Hearing Officer's order.[79] Although Lee does not challenge the entry of the preclusion order in the first instance, he asserts that FINRA should have admitted the e-mail at the hearing when he introduced it during his direct testimony. He argues that the e-mail was "rebuttal" evidence, offered to discredit Cantrell's testimony, explaining that he "was unaware Cantrell" would contend "that he was not the supervisor until he actually heard Mr. Cantrell's testimony."

Based on the record before us, we find that FINRA did not abuse its discretion in excluding the Cantrell e-mail from evidence.[80] Lee cites no authority for his claim that the e-mail was "rebuttal" evidence. The term generally applies to evidence offered by the plaintiff to

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[78] *Kresge*, 90 SEC Docket at 3087 (finding that firm president failed reasonably to delegate supervision to branch office managers, where president "did nothing to follow up and review their performances").

[79] FINRA Code of Procedure Rule 9280(b)(2) authorizes a Hearing Officer to preclude evidence of a party at the subsequent hearing if the party "without justification fail[ed] to disclose information required" by a pre-hearing order. The NAC upheld the Hearing Officer's ruling.

[80] *See, e.g., Mercado v. Ahmed*, 974 F.2d 863, 872 (7th Cir. 1992) ("It is well established that the admission of rebuttal evidence lies within the sound discretion of the trial court and appellate courts will not interfere with the trial court's ruling unless there is a clear abuse of discretion." (citation omitted)).

meet new facts brought out by the defense's case-in-chief.[81] There is also no support for Lee's claim that he was "unaware" of Cantrell's position. FINRA's complaint charged Lee, not Cantrell, with failure to supervise. FINRA also explicitly stated in its pre-hearing brief (which predated the preclusion order) that "Cantrell, whom Lee has tried to portray as their supervisor, . . . will . . . testify that he performed mostly administrative and clerical tasks, and did not supervise any registered representative."[82] In any event, the contents of the e-mail do not add to what Lee claimed in his testimony: that Cantrell was a designated supervisor. If that were so, as discussed, Lee nonetheless was required as president "with overall supervisory responsibilities" to ensure that Cantrell was performing whatever supervisory duties that were assigned to him. Despite numerous red flags in the Firm's iStorage trading, Lee failed to discharge that duty.[83]

Accordingly, we find that Applicants violated NASD Rules 3010(a) and 2110 by failing to supervise Centeno and Santohigashi with a view to ensuring compliance with the Securities Act and NASD rules. Applicants also violated NASD Rule 3010(b) and 2110 by failing to establish adequate procedures to ensure compliance with applicable requirements.

## 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," that the sanctions are "excessive or oppressive" or impose an unnecessary or inappropriate burden on competition.[84] For unlawfully selling securities without registration, FINRA fined Midas

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[81] *Lubanksi v. Coleco Indus., Inc.*, 929 F.2d 42, 47 (1st Cir. 1991) ("'Rebuttal [evidence] is a term of art, denoting evidence introduced by a plaintiff to meet new facts brought out in [the] opponent's case in chief.'" (quoting *Morgan v Commercial Union Assurance Co.*, 606 F.2d 554, 555 (5th Cir. 1979)); *see also* 22 Wright & Graham, *Fed. Prac. & Proc.: Evidence* § 5177, at 147 (1st ed. 1978) (noting that "'rebuttal evidence' properly so-called" is where "the proponent argues that his evidence should be admitted, not because of a logical relationship to the issues framed by the pleadings but because of a relationship between it and evidence already introduced by his opponent").

[82] FINRA's pre-hearing materials also included Cantrell's OTR testimony given to FINRA during its investigation, which provided Lee with further notice of Cantrell's position.

[83] *Owsley*, 51 S.E.C. at 535 (finding that 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"); *see also Sanders*, 53 S.E.C. at 904 (explaining that "where supervisory responsibility is shared between firm executives, each can be held liable for supervisory failure").

[84] 15 U.S.C. § 78s(e)(2). Applicants do not claim, nor does the record show, that

(continued...)

$30,000. For failing to supervise Centeno and Santohigashi and having deficient written procedures, FINRA aggregated its sanctions against Midas and Lee, fining each $50,000 and suspending Lee from associating with any FINRA member for two years in all principal capacities.

We initially observe that the sanctions FINRA imposed were consistent with the recommendations set forth in FINRA's Sanction Guidelines.[85] For the unregistered sale of securities, the Guidelines recommend a fine between $2,500 and $50,000, (plus any financial benefit respondent may have derived) and, in egregious cases, a suspension of the respondent for up to two years or a bar. For failure to supervise, the Guidelines recommend a fine between $5,000 and $50,000 and a suspension up to thirty 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 of the firm for thirty days and thereafter until the procedures are amended to conform to rule requirements.

We agree with FINRA that Midas'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."[86] We have further "stressed the responsibility of brokers to prevent their firms from being used as conduits for illegal distributions."[87] The record establishes that Midas gave little regard for this critical duty, allowing Mihaylov, a known stock promoter, to use his Midas account to liquidate large blocks of penny stocks without questioning his activities.

FINRA Guidelines additionally recommend the consideration of any attempts by Applicants "to comply with an exemption from registration" and "the share volume and dollar amount of the transactions involved." Midas, however, made no effort to comply with the Section 4(4) exemption, failing to conduct any inquiry into Mihaylov's iStorage stock before selling it in the over-the-counter market over a two-month period. The Firm's unregistered sale

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[84] (...continued)
FINRA's action imposed an unnecessary or inappropriate burden on competition.

[85] 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 Inst'l Trading, LLC*, Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802, 13814 n.38.

[86] *Gilligan, Will & Co.*, 267 F.2d 461, 463 (2d Cir. 1959).

[87] *Apex Fin. Corp.*, 47 S.E.C. 265, 269 (1980); *Wonsover*, 54 S.E.C. at 17 ("[I]n light of the cardinal role occupied by broker-dealers in the securities distribution process, we cannot overemphasize the importance of their obligation to take all reasonable steps to avoid participation in distributions violative of [the registration provisions of the Securities Act]." (internal alteration omitted) (quoting *L.A. Frances, Ltd*, 44 S.E.C. 588, 593 (1971))).

of 760,000 shares of iStorage stock was a significant volume of shares for a single customer and yielded approximately $102,000 in sales proceeds over a two-month period.

FINRA's imposition of serious sanctions for Applicants' supervisory failings was also warranted, as Midas's supervisory system regarding the unregistered sale of securities was virtually nonexistent. We have emphasized that "[p]roper 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."[88] The applicable Guidelines call for consideration of whether Applicants "ignored 'red flag' warnings that should have resulted in additional supervisory scrutiny." As discussed, the registered representatives' iStorage trading presented considerable red flags—in particular, the sale of a large block of a recently issued, obscure stock for a known stock promoter—yet Applicants ignored this obvious need for inquiry.

The Guidelines further instruct adjudicators to consider whether deficient supervisory written procedures "allowed violative conduct to occur or to escape detection." We agree with FINRA that Midas 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." Midas's written supervisory procedures also gave the Firm's sales personnel no meaningful guidance for determining whether a given sale was exempt from registration. Rather, as FINRA found, Applicants left all "responsibility for compliance with the Securities Act" to third parties, such as transfer agents and clearing firms. Applicants denied that they had any responsibility of their own.[89]

We also treat Applicants' November 2004 AWC involving similar violations of Securities Act Section 5 as an aggravating factor. The AWC itself stated that it "may be considered in any future actions brought by [FINRA]." "We have long recognized that prior disciplinary history . . . provides evidence of whether an applicant's misconduct is isolated, the sincerity of the applicant's assurance that he will not commit future violations and/or the egregiousness of the applicant's misconduct."[90] FINRA Guidelines also state that "[d]isciplinary sanctions should be more severe for recidivists . . . [as] past misconduct . . . evidences disregard for regulatory

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[88] *Dennis S. Kaminski*, Exchange Act Rel. 65347 (Sept. 16, 2011), __ SEC Docket __, __ (collecting cases).

[89] *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").

[90] *Consolidated Inv. Servs.*, 52 S.E.C. 582, 591 (1996); *see also Gregory O. Trautman*, Exchange Act Rel. No. 61167 (Dec. 15, 2009), 97 SEC Docket 23492, 23527 n.85 (stating that, in factoring in disciplinary history, "we have considered orders in both settled and litigated proceedings" (citing *Pagel, Inc. v. SEC*, 803 F.2d 942, 948 (8th Cir. 1986)).

requirements, investor protection, or commercial integrity." Applicants' repeated misconduct underscores the egregiousness of their violations and demonstrates a conscious disregard for their regulatory obligations.[91] Although Applicants previously assured FINRA that they were committed not to let similar Section 5 violations happen again, they quickly broke that commitment six weeks later. Such recidivism indicates "the need for sanctions severe enough to deter further misconduct, and to impress [upon Applicants] the need for scrupulous compliance" in their future dealings.[92]

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 find that Applicants' failure to conduct any inquiry or to ensure compliance with Securities Act Section 5 was at least reckless, particularly given the November 2004 AWC, the numerous red flags raised by the stock, and the lack of concern exhibited at Midas for safeguarding investors from the threat of illegal distributions.[93]

Applicants further argue that FINRA's imposition of a two-year suspension against Lee is "particularly excessive" because, as Applicants claim, "Lee is an indispensable person in the firm's" direct market access trading program and the Firm no longer conducts retail securities business. Applicants assert that the "chances of finding . . . another Korean-speaking principal with the necessary FINRA licenses . . . are remote," imperiling the Firm's "substantial Korean business." They contend that their argument is consistent with the General Principles of

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[91] *Cf. Carley*, 92 SEC Docket at 1731-32 (finding broker's continued "violations of Securities Act Section 5, after being sanctioned for similar conduct . . . , justify a bar from association with any broker or dealer").

[92] *Lowell H. Linstrom*, 48 S.E.C. 609, 613 (1986). The NAC also found "particularly aggravating" statements Lee apparently made in his OTR testimony that "it was his opinion that Midas . . . representatives did not have a duty to determine whether unregistered securities were freely tradable and that he would *prohibit* them from contacting an attorney to assist them in making this determination" (emphasis in original). Lee's OTR testimony was not admitted into evidence, so we have not considered it in conducting our *de novo* review. A FINRA examiner's hearing testimony, which Lee does not contest, introduced Lee's OTR statements to a lesser degree, stating that Lee told investigators that, "if anybody at [Midas] had tried to undertake efforts to determine whether . . . unlegended certificate securities were free trading, he would not have allowed it." Given this testimony and the substantial evidence that Lee abdicated his supervisory responsibilities despite his earlier settlement of the AWC, we find that the sanctions FINRA imposed against Lee were neither excessive nor oppressive but were remedial, in the public interest, and for the protection of investors.

[93] *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").

FINRA's Sanction Guidelines, which recommend the consideration of a firm's size and available resources,[94] and suggest imposition of alternative sanctions that limit Midas's "right to engage in any future retail business or prohibit Mr. Lee from acting as a supervisor in connection with such retail business."

We do not view Lee's two-year suspension "in all principal capacities" as excessive or oppressive and thus decline to modify the sanctions. Midas's claimed economic harm does not outweigh our concerns that Lee poses a continued threat to investors, warranting a significant time out from serving in a principal capacity.[95] Lee's failings as a supervisor were instrumental to allowing the Firm's unlawful sales to take place for a two-month period. Moreover, his Firm's multiple violations of Securities Act Section 5—a requirement that we have stated lies at "the heart of the securities regulatory system"[96]—constitute repeated fundamental failures to meet his obligations as a securities principal. Although Applicants do not explain why Lee's "FINRA licenses" are "necessary" given that Midas is no longer a FINRA member, we believe imposition of a principal suspension remains nevertheless important because nothing would prevent Lee from associating in that capacity with another member firm during his period of suspension.[97]

We accordingly find the sanctions FINRA imposed appropriately remedial. Applicants' failure to discharge their duties as securities professionals caused 760,000 shares of an unknown stock to be sold to investors without registration or an exemption therefrom, depriving investors of the protections afforded by the registration and disclosure requirements of the Securities Act. As we have repeatedly 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 inquiry to obtain sufficient

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[94] The General Principles state that adjudicators "should consider firm size with a view toward ensuring that the sanctions imposed are not punitive but are sufficiently remedial to achieve deterrence."

[95] *Hans N. Beerbaum*, Exchange Act Rel. No. 55731, 90 SEC Docket 1863, 1871-72 & n.22 (May 9, 2007) (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").

[96] *Kirby*, 56 S.E.C. at 72.

[97] According to the CRD, about one month after the Hearing Panel's decision in this matter, Lee became the CEO, CCO, and over 75% owner of Midas Execution Services LLC, an Illinois-based broker-dealer, whose application for FINRA membership is pending.

information to justify their activity in the security.'"[98] The sanctions imposed serve the public interest and protect investors by encouraging others in the securities industry, as well as Applicants, to ensure compliance with the Securities Act before engaging in the unregistered sale of securities on behalf of their customers and to conduct watchful supervision of these activities to avoid facilitating the unlawful distribution of securities.[99]

An appropriate order will issue.[100]

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

Elizabeth M. Murphy
Secretary

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[98] *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)).

[99] *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.").

[100] 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. 66200 / January 20, 2012

Admin. Proc. File No. 3-14308

In the Matter of the Application of

MIDAS SECURITIES, LLC, and JAY S. LEE
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 Midas Securities, LLC, and Jay S. Lee be, and they hereby are, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary