BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee for District No. 5 Complainant, v. John P. Goldsworthy 1820 Hickory Ave., Apt. B Harahan, LA 70123 and 3535 Houma Blvd., #136 Metaire, LA 70002 Respondent.	DECISION Complaint No. C05940077 Dated: October 16, 2000

On remand from the Commission, DBCC found that the evidence supported the finding that the promissory notes at issue were securities. Held: affirm DBCC's finding that the notes were securities and that respondent engaged in private securities transactions without providing prior written notice to and obtaining prior written approval from the NASD member firm with which he was then associated; affirm sanctions of bar in all capacities and award of costs.

John P. Goldsworthy ("Goldsworthy") has appealed a March 1, 2000 decision of the District Business Conduct Committee for District No. 5 ("DBCC"). After a review of the entire record in this matter, we affirm the DBCC's finding that the promissory notes at issue constituted securities and that Goldsworthy violated NASD Conduct Rules 2110 and 3040[1] by engaging in private securities

[1] Rule 115 indicates that persons associated with a member shall have the same duties and obligations under the NASD's Rules as members.

transactions without providing prior written notice to and obtaining approval from the member firm with which he was then associated, U.S. Securities Clearing Corporation ("USSC"). We order that he be barred and assessed costs.

Procedural Background

On October 31, 1994, the DBCC issued the complaint, which was comprised of two causes. The first cause alleged that from April 19, 1993 through December 1, 1993, Goldsworthy participated in private securities transactions without providing prior written notice to and obtaining approval from USSC, in violation of Article III, Sections 1 and 40 of the Association's Rules of Fair Practice (now known as and hereinafter referred to as "Conduct Rules 2110 and 3040"). Specifically, the complaint alleged that Goldsworthy signed and issued $499,744 in promissory notes to 12 public customers (there were eight individual customers and two pairs of married couples) of Smith Barney Shearson, Inc. ("Smith Barney"), on behalf of SCF, Inc. ("SCF").[2] There were a total of 18 transactions, because one individual purchased one note for herself and six notes on behalf of her grandchildren, two other individuals purchased two notes each, and the remaining five individuals and two couples each purchased one note. When SCF issued the notes (the "SCF Notes"), Goldsworthy was President of SCF.

The second cause alleged that, in connection with the issuance of the SCF Notes to Smith Barney customers, Goldsworthy sold unregistered securities in violation of Section 5 of the Securities Act of 1933, accepted funds from public customers without describing how the funds would be used, and failed to provide the customers with a satisfactory accounting of the funds, all in violation of Conduct Rule 2110.

A hearing was conducted before a hearing subcommittee of the DBCC on February 12, 1996 ("Initial Hearing"). On May 31, 1996, the DBCC issued a decision ("Initial DBCC Decision") making findings against Goldsworthy as alleged in both causes of complaint. Goldsworthy appealed this decision to the National Business Conduct Committee ("NBCC"),[3] which issued a decision dated May 21, 1997, dismissing the second cause and affirming the findings under the first cause. The NBCC decision censured Goldsworthy, barred him from association with any member firm, imposed a fine of $50,000, ordered him to pay restitution to Smith Barney in the amount of $499,744, and assessed hearing costs.

Goldsworthy appealed the NBCC decision to the Securities and Exchange Commission ("Commission"), which vacated the decision and remanded the matter to the NASD, holding that the evidence of record was insufficient to determine whether the SCF Notes were securities, as alleged in the first cause. More specifically, the Commission noted that the issue of whether the SCF Notes were

[2] "SCF" stands for "St. Charles Funds."

[3] The NBCC was the precursor to the current National Adjudicatory Council ("NAC").

securities was controlled by the test set forth by the Supreme Court in Reves v. Ernst & Young, 494 U.S. 56 (1990) ("Reves") and directed the NASD to:

> . . . marshall evidence concerning the circumstances surrounding the sale of notes from which the reasonable motivations and expectations of the noteholders, as well as the plan of distribution may be discerned, to analyze that evidence, and to apply Reves to determine if the notes at issue are securities . . .

In re John P. Goldsworthy, Exchange Act Rel. No. 40000 (May 18, 1998), at p. 4.

On October 25, 1999, a remand hearing in this matter was held before a hearing subcommittee of the DBCC in New Orleans, Louisiana ("Remand Hearing"). Goldsworthy and seven other witnesses, including three of the SCF Note purchasers, testified. Additional exhibits, including investor questionnaires from seven of the SCF Note purchasers, were entered into the record at the Remand Hearing, and the DBCC considered the new evidence together with the record previously established during the Initial Hearing in the case.

In a March 1, 2000 decision on remand ("DBCC Remand Decision"), the DBCC found that the record supported the finding that the SCF Notes were securities under the Reves test and that therefore, Goldsworthy had violated NASD Conduct Rules 2110 and 3040 by participating in private securities transactions without prior written notice to and approval from USSC. The DBCC barred Goldsworthy in all capacities and imposed costs of $2,502.

Goldsworthy filed this appeal of the DBCC Remand Decision.

Goldsworthy's Background

Goldsworthy first became registered with the Association as a general securities representative in May 1981. From December 1992 through July 1994, the time of the events at issue in this proceeding, Goldsworthy was associated with USSC as a general securities representative. Goldsworthy is not currently associated with an NASD member firm.

Goldsworthy was prosecuted in Louisiana state court under a bill of information for his role in the SCF default, and on September 13, 1995 he pleaded guilty to attempted theft and the sale of unregistered securities. For his state infractions, Goldsworthy received a sentence of six months' imprisonment, which was suspended; two years of inactive probation; a $10,000 fine; and an order to pay restitution to customer BB ("BB").

Factual Background

From April through December 1993, Goldsworthy maintained at Smith Barney an account in the name of SCF, for which he was the signatory. The NASD opened an investigation after William Ryan ("Ryan"), a representative in Smith Barney's New Orleans office, was "permitted to resign" from that firm. Ryan had been soliciting funds from his customers for SCF. Smith Barney permitted Ryan to resign after Smith Barney discovered the SCF transactions. Ryan committed suicide shortly after his termination.

Ryan had solicited his Smith Barney customers to invest their funds in SCF and instructed the customers that the money raised from these transactions would be used as "seed" money to start a mutual fund -- the St. Charles Mutual Fund ("St. Charles Fund") -- and an investment advisory firm. In exchange for their funds, the Smith Barney customers were given promissory notes wherein SCF was identified as the borrower. Goldsworthy signed these notes as president of SCF. Under the terms of the notes, SCF was to pay the customers interest at a rate of 10 percent per annum until the notes were repaid in full. The purchasers could make written demand for repayment of the notes, at which time SCF would be required to pay the aggregate outstanding principal and all accrued and unpaid interest within 60 days of demand. Each note provided that it was issued to the lender to evidence a loan to SCF to fund certain start-up costs in connection with the formation of an investment advisory firm and an investment company to be formed by SCF.

According to Goldsworthy, he did not participate in the solicitation of the monies from the customers. Most of the funds obtained from the customers were transferred out of the customers' Smith Barney accounts by means of letters of authorization, and checks thereafter were issued by Smith Barney to Goldsworthy or SCF and deposited into the SCF account at Smith Barney.

Although the customers eventually demanded repayment, neither Goldsworthy nor SCF ever repaid the notes to the customers. An NASD staff examiner noted that Smith Barney had repaid its customers approximately $500,000, plus interest, for the monies that those customers had lent to SCF.[4]

Goldsworthy admitted that the notes were not backed by collateral. Goldsworthy's intention was to repay the notes out of proceeds from the sale of mutual fund shares, which would ultimately result in fees to the investment management company, which would be obligated to repay SCF. Goldsworthy admitted, however, that the notes were demand notes and that if the investors had demanded repayment prior to the mutual fund's being operative, the "entire situation would collapse." Goldsworthy acknowledged that there was no written disclosure of risks, either on the face of the notes or elsewhere, but he stated that it was not his fault that the risks were not disclosed to investors.

Goldsworthy admitted that USSC did not give him written permission either to sell or issue the notes. According to Goldsworthy, however, he gave USSC copies of the first two notes for SCF, the

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[4] Counsel for Smith Barney represented that the firm had repaid many (but not all) of the customers (in excess of $400,000) for their losses because the losses resulted from the misconduct of Ryan, an agent of the firm.

sales of which occurred in 1992, prior to Goldsworthy's employment with USSC. Goldsworthy argued that since USSC was aware of these notes issued in 1992, that awareness was notice to USSC of the notes issued in 1993. Goldsworthy admitted, however, that USSC was unaware of the 1993 notes. He further admitted that he did not provide USSC with any record pertaining to the individual transactions. In addition, James Miranti ("Miranti"), the president of USSC, stated in a letter dated May 6, 1994 ("the Miranti Letter") to NASD staff that a principal of the firm had given Goldsworthy verbal permission to sell shares in the St. Charles Fund, but that Goldsworthy never received permission to obtain loans.[5]

Discussion

A. The SCF Notes. The Commission remanded this case to the NASD for the sole purpose of analyzing whether the SCF Notes constituted securities under the standards set forth in Reves. Each of the SCF Notes provided that: the holder would be paid 10 percent interest per year until the note was repaid in full; demand for payment of principal and interest could be made at any time, following which the maker would be obligated to make payment in full within 60 days; the maker could prepay the note at any time without penalty; and the maker, at its option, could make payment either in cash or in units of any mutual fund having a value equal to the amount due under the note.[6]

Each note also stated on its face that the proceeds would be used to fund certain start-up costs in connection with the formation of an investment advisory firm and a mutual fund, and that "under no circumstances shall this promissory note be deemed to grant to lender any option to purchase shares of any mutual fund, it being understood that the form of repayment thereof shall be at the option of Borrower." Neither Goldsworthy nor SCF responded to demands from holders for redemption of the notes, and the mutual fund never came into being.

Goldsworthy makes two arguments. First, he contends that the instruments were not securities when he issued them. As Goldsworthy stated, "[T]he notes were not securities when SCF, Inc. gave them to Smith Barney . . . ." Second, Goldsworthy argues that he cannot be held responsible for participation in prohibited private securities transactions because the SCF Note purchasers' understanding of the nature of the transactions resulted not from his actions, but from the actions of Smith Barney.

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[5] In addition, there was much testimony from Goldsworthy, various Smith Barney employees, counsel for Smith Barney, and an NASD examiner as to whether Smith Barney was aware that Ryan had solicited loans for SCF and Goldsworthy. We agree with the DBCC's finding that the key issue in this regard was not Smith Barney's knowledge but whether Goldsworthy had given prior written notice to USSC regarding the SCF Notes.

[6] All of the SCF Notes in question are in the record in this matter, except for a note issued to customer JC ("JC"). To evidence that transaction, a copy of a check in the amount of $25,000, payable to "St. Charles family of funds," from JC was submitted for the record at the time of Goldsworthy's appeal of the Initial DBCC Decision to the NBCC.

The answer to both of these arguments is the same. Although the SCF Notes may have begun as no more than paper and ink, they became securities when Goldsworthy issued them and arranged for Ryan to launch them into the stream of commerce. Liability under Conduct Rule 3040 can be based upon more limited involvement in a securities transaction than exists in this case, and encompasses situations in which the customer's decision to purchase the security resulted from the activity of persons other than the respondent. Moreover, notwithstanding his claims to the contrary, Goldsworthy's actual involvement in the SCF transactions was extensive.

B. The Reves Analysis. As the Commission stated in its decision remanding this matter, an inquiry into whether a particular note is a security must be made under the test articulated by the Supreme Court in Reves. In that case, the Supreme Court explained that although the definition of a "security" under the Securities Exchange Act of 1934 ("Exchange Act") begins with "any note,"[7] and a note is presumed to be a security, this term is not to be taken literally. In accordance with Reves, every note is first presumed to be a security, but the presumption may be rebutted under either step of a two-step analysis.

Under the first step of the Reves analysis, we must examine the SCF Notes to determine whether they bear a strong "family resemblance" to any of the seven types of notes that the Supreme Court has determined are not securities:

1) the note delivered in a consumer financing;
2) the note secured by a mortgage on a home;
3) the short-term note secured by a lien on a small business or some of its assets;
4) the note evidencing a "character" loan to a bank customer;
5) the short-term note secured by an assignment of accounts receivable;

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[7] Under the Exchange Act, "security" is defined as "any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 U.S.C. § 78c(a)(10).

6) the note which formalizes an open account debt incurred in the ordinary course of business, particularly if it is collateralized; and
7) the note which evidences a loan by a commercial bank for current operations.

Reves, 494 U.S. at 65-67.

The SCF Notes on their face do not bear a strong "family resemblance" to any of the seven types of notes the Supreme Court has held are not securities. Therefore, Reves requires that the second step of the analysis be conducted: we must examine four factors in order to determine whether another category of note should be added to the list of seven exempt notes. Id. The four factors that might prompt a tribunal to exclude a note from legal classification as a security are as follows:

1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction;
2) the plan of distribution of the note;
3) the reasonable expectations of the investing public; and
4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

The evidence presented as to these four factors does not persuade us that a new category of note should be added to the list of seven exempt notes acknowledged in Reves. The evidence and arguments as to each of the four factors is as follows.

1) Motivations of Buyer and Seller. Reves states that the motivations of the buyer and seller must be analyzed as follows:

> If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cashflow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."

Reves, 494 U.S. at 66.

The SCF Notes were sold to raise money for the general use of a business enterprise. This business purpose was expressly stated on the face of every SCF Note, which stated that the notes were

issued "to fund certain start-up costs in connection with the formation of an investment advisory firm and an investment company to be formed by [SCF, Inc.]." Goldsworthy understood this business purpose. In correspondence to the NASD, Goldsworthy stated that monies were to be raised by Ryan as "seed capital" for the mutual fund. Goldsworthy also testified at the Initial Hearing in this matter that the monies were raised for ". . . a private company whose mission was to finance a mutual fund."[8] On appeal, Goldsworthy stated that SCF had lent $100,000 of the funds raised to the mutual fund to satisfy a regulatory requirement of minimum capital for the fund.

The purchasers of the SCF Notes were primarily motivated in their purchase decisions by the profit the notes were to generate. Customer CW ("CW") testified at the Remand Hearing that he purchased a promissory note on September 22, 1993, in the amount of $16,600 with funds from his Smith Barney account. It was CW's understanding that the monies would be used to "start up some type of fund." CW testified that he was motivated to purchase the note because ". . . he could do better buying this note at ten percent than buying bonds." CW also testified that the interest rate was important to him.[9]

BB also testified at the Remand Hearing. He purchased a $10,000 promissory note on May 3, 1993. He testified that he was motivated to buy the note because he understood that it was "basically risk free" and it would earn 10 percent, which "was much higher than a money market."[10]

Finally, customer AQ ("AQ") testified at the Remand Hearing. He purchased two SCF Notes totaling $50,000 on April 19, 1993.[11] When asked why he purchased the notes, AQ stated "Interest. Mainly interest . . . ."

Additional investor questionnaires were entered into the record which corroborated the testimony of the three customers who had testified in person at the Remand Hearing.[12] Customer VB

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[8] There is no evidence that funds were to be used to fund a discrete component or department of the enterprise, or for specific commercial uses such as remedying a cash flow deficit or purchasing a specific asset. Instead, it is clear from the record that the monies were raised to fund the enterprise generally. See Stoiber v. Securities and Exchange Commission, 161 F.3d at 745, 750 (D.C. Cir. 1998), cert. denied, 1999 U.S. LEXIS 2642, 119 S.Ct. 1464, 143 L.Ed.2d 549 (1999).

[9] CW's Investor Questionnaire was also entered into the record at the Remand Hearing and it is consistent with his testimony. It states "I was told that I was making a loan to the Smith Barney St. Charles Fund for start up costs. I could get back my investment plus 10% interest within one year."

[10] BB's Investor Questionnaire, letters regarding this matter from BB and his attorney, and a customer account statement were entered into the record at the Remand Hearing. Although the Investor Questionnaire does not specifically address the issue of the interest payments on the note, it does not contradict any of BB's testimony at the Remand Hearing.

[11] AQ's Investor Questionnaire was entered into the record at the Remand Hearing. Although AQ's Investor Questionnaire does not specifically address the issue of interest on the SCF Notes, it does not contradict his testimony at the Remand Hearing.

("VB"), who purchased a $22,000 note on December 1, 1993, stated in her Investor Questionnaire that she ". . . wrote the check for $22,000 it was spose [sic] to yield 10% . . . ." Customer MC ("MC"), who purchased a $200,000 note on May 5, 1993, stated in her Investor Questionnaire that her understanding of the note was that ". . . I was to invest the money which would pay 10% a year. It would be returned to me with interest . . ." and that "Mr. Ryan suggested this investment as a safe 10% investment . . . ."

Customers LS and HS purchased an $11,000 note in July 1993. LS provided an Investor Questionnaire which stated that he was told that the ". . . St. Charles Family of Funds would pay 10% and was the best we could get . . . ." Customer SS ("SS") purchased a total of $110,144 in promissory notes for herself and her grandchildren in July and August 1993. SS provided an Investor Questionnaire which stated that she understood when she purchased the notes that ". . . it was an investment made by my broker . . . and 10% interest, available to me in 60 days upon request . . . ."

All of the investor questionnaires that were entered into the record at the Remand Hearing are hearsay. In determining whether to give this hearsay any weight, we must consider the probative value, reliability, and fairness of the use of the questionnaires. See e.g., In re Carlton Fleming, 52 S.E.C. 409 (1995) (affidavits corroborated by other evidence); In re Michael A. Niebuhr, 52 S.E.C. 546 (1995) (written declaration given weight). Regarding the material facts, the declarations are consistent with each other, the customers' testimony, certain correspondence more contemporaneous to the events at issue, the SCF Notes, and other transactional information. Significantly, Goldsworthy did not cross-examine any of the three customer witnesses about their investor questionnaires, or otherwise question the content of any of the other investor questionnaires. For these reasons, we conclude that the questionnaires should be given weight because they are sufficiently reliable and probative.

We find, from the testimony of the customers and the corroborative statements in the investor questionnaires, that profit was the primary goal of the SCF Note purchasers.[13] Therefore, under the relevant Reves factor, first factor of Reves, the SCF Notes are properly classified as securities because the monies were raised for a general business use, and the customers invested to generate a profit.

2) Plan of Distribution. Under the second Reves factor, the plan of distribution of the note is examined in order "to determine whether it is an instrument in which there is common trading for speculation or investment." Reves, 494 U.S. at 66. If there is common trading, the instrument is more likely to be a security. Common trading is established where notes are "offered and sold to a broad segment of the public." Id. at 68. Further, common trading is indicated where individuals, rather than sophisticated institutional investors, are the offerees of the notes in question. Stoiber, 161 F.3d at 751. There is no evidence of any secondary market trading in the SCF Notes. However, common trading is

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[12] The examiner who conducted the examination identified the questionnaires of the customers who did not testify.

[13] A favorable rate of interest, such as the 10 percent offered in the SCF Notes, has been held to be an indicator that profit may be the primary goal of a note purchaser. Reves, 496 U.S. at 67-68.

indicated by Ryan's sale of the notes to individual retail customers rather than institutional investors. Despite Goldsworthy's contentions that the SCF Notes were intended to be sold to sophisticated investors, the record shows that the SCF Note purchasers included retired persons of limited means and persons who invested on behalf of small children. Goldsworthy testified that he never refused to accept any of the funds that were obtained from the sales of the SCF Notes to these customers. Accordingly, we conclude that there was common trading of the SCF Notes.

3) The Reasonable Expectations of the Investing Public. The third Reves factor considers the reasonable expectations of the investing public. A note will be regarded as a security under the third factor if that note is reasonably believed by a purchaser to be an investment. When the seller calls a note an "investment," it is reasonable for a purchaser to take the seller at his word. Reves, 494 U.S. 1569. Another indication that the SCF Notes were securities was the fact that they specifically provided that the maker could prepay the notes at any time without penalty, and that such payment could be made either in cash or in units of a mutual fund in equal value to the amount due under the SCF Note.

CW testified that he bought the note as an alternative to a bond. "We could do better at buying this note at ten percent than buying bonds."[14]

BB testified:

Q. What did Mr. Ryan tell you about this note?

A. Well, the thing that stuck in my mind mostly it was basically risk free. It was as good as a triple A rated bond, the Jennie [sic] Mae, which is mostly what I bought at that time. It was short term, and it was ten percent interest and [I] had some money I was looking to invest that way.[15]

AQ testified that he purchased the notes because of "interest and also investment."[16]

The balance of the investor questionnaires for customers who did not testify are consistent on this point. LS stated in the Investor Questionnaire that he submitted on behalf of himself and his wife, HS, that "the St. Charles Family of Funds was a good safe investment," that "it was a Smith Barne [sic] Shearson, Inc. product and it was a good, safe investment" and that "the funds for this investment came from a debenture which was called."

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[14] CW's Investor Questionnaire also described the note as an "investment." "I was told . . . I would get back my investment plus 10% interest . . ." and "Mr. Goldsworthy assured me that I could get my investment back at any time within one year . . .".

[15] BB's Investor Questionnaire stated that the SCF Note would be a "short term investment."

[16] AQ's Investor Questionnaire stated that the notes were ". . . just another fund to invest my extra cash as I have done so many times."

VB thought she was investing in a "reputable fund" when she purchased the note. MC understood that she was to ". . . invest the money which would pay 10% per year" and that "Mr. Ryan suggested the investment as a safe 10% investment . . . ." SS was told that the note ". . . was a safe, short term investment . . ." and that ". . . it was an investment made by my broker . . . ."

Goldsworthy maintains that he did not refer to the notes as investments,[17] and there are a few references by customers to the note transactions as "loans" in the questionnaire responses. This is immaterial under Reves, however, because the third factor is a "one-way ratchet." Stoiber, 161 F.3d at 751. In other words, the "expectations" test allows notes that would not be deemed to be securities under a balancing of the other three factors nonetheless to be treated as securities if the public has been led to believe they are. It does not, however, allow notes deemed to be securities under the other three factors to escape classification as securities. Id. Thus, although the customer questionnaire answers referring to the SCF Notes as "investments" indicate that the notes are securities, no amount of evidence that anyone called the transactions "loans" would prove that the notes were not securities. Notwithstanding any possible variation in customer understanding as to the character of the instruments, the objective circumstances surrounding the marketing of the instruments (specifically, that they were sold from the offices of a broker-dealer by a representative of that broker-dealer, and were purchased primarily with customer funds residing in investment accounts held by that broker-dealer) lend strong support to the view that the instruments were investments. We thus conclude that the offerees viewed the SCF Notes as an "investment," and that under the third factor of Reves, the SCF Notes should be viewed as securities.

4) Need for Federal Securities Law. The fourth Reves factor considers whether other regulatory schemes, collateral, or insurance protects the purchaser of a note so that there is less need for regulation by the federal securities laws. For example, the securities laws do not need to reach bank certificates of deposit, which are insured by the Federal Deposit Insurance Corporation ("FDIC") and subject to substantial federal banking regulation. See Reves, 494 U.S. 67, 69.

The SCF Notes were unsecured and uninsured. Goldsworthy admitted that the notes were not collateralized. Moreover, the SCF Notes were not subject to any regulatory scheme providing oversight over the transactions. Contrary to Goldsworthy's assertions, state law provisions allowing for enforcement of promissory notes in the courts are not "regulatory schemes" as contemplated by Reves. Stoiber, 161 F.3d at 751. Thus, the SCF Notes must be regarded as securities under the fourth Reves factor.

In sum, our consideration of the SCF Notes under the Reves analysis demonstrates that the notes bore no resemblance to the seven types of notes excluded from classification as securities, and there is no reason to suggest that they should be treated as a new type of non-security. See generally In re Robin Bruce McNabb, Exchange Act Rel. No. 43411 (Oct. 4, 2000). The SCF Notes simply fit within the familiar class of instruments issued to investors for the purpose of raising money for the start

[17] CW stated in his Investor Questionnaire, however, that Goldsworthy told him he could get his "investment back at any time."

up of a new business venture. See, e.g., Trust Company of Louisiana v. N.N.P. Inc., 104 F.3d 1478 (5th Cir. 1997) (notes sold to raise money for general use of non-existent telephone company held to be securities). Thus, we conclude that the SCF Notes must be classified as securities under Reves.[18]

C. The Remaining Elements of a Private Securities Transaction Violation. We note that the evidence introduced in the Initial Hearing, which was not questioned by the Commission and is not at issue here, substantially supports all of the other elements of a private securities transaction rule violation. Conduct Rule 3040 prohibits any person associated with a member firm from participating in any manner in a private securities transaction outside the regular course of his or her employment unless that person provides prior written notice to the member "describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction." The Commission outlined the importance of the prohibition on private securities transactions in In re Anthony J. Amato, et al., 45 S.E.C. 282, 285 (1973):

> The regulatory scheme under the Exchange Act, in which the NASD is assigned a vital role, imposes on broker/dealer entities and NASD member firms the responsibility to exercise appropriate supervision over their personnel for the protection of investors. Where employees effect transactions for customers outside of the normal channels and without disclosure to the employer, the public is deprived of protection which it is entitled to expect. Moreover, the employer may also thus be exposed to risks to which it should not be exposed. Thus, such conduct is not only potentially harmful to public investors, but inconsistent with the obligation of an employee to serve his employer faithfully . . . . There is always a possibility in these situations that some improper conduct may be involved or that the employer's interests may be adversely affected. At the least, the employer should be enabled to make that determination. (Footnotes omitted).

Further, if the transaction is for compensation, the member firm must approve or disapprove of the proposed transaction in writing. The instant record shows that Goldsworthy did receive compensation from the transactions in that he received $84,500 of the note sale proceeds in the form of checks drawn on SCF's account payable to him or to "cash." Goldsworthy admitted that approximately $35,000 of this amount was paid to him as salary for his work as president of SCF. He also admitted that he used $1,750 of SCF funds to pay a fine assessed against him in an unrelated NASD proceeding.

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[18] The fact that the SCF Notes were demand notes does not influence our analysis, even though the Exchange Act definition of security includes an exclusion for ". . . any note . . . which has a maturity at the time of issuance of not exceeding nine months . . . ." 15 U.S.C. § 78c(a)(10). Reves found that the nine months or less exclusion was intended to apply only to commercial paper ("Short term, high quality investments issued to fund current operations . . . ," 494 U.S. at 70), and noted that a demand note would have a maturity of less or greater than nine months by its very nature, 494 U.S. at 72-73. The SCF Notes were not commercial paper, and did not come within this exclusion.

The Commission has upheld Conduct Rule 3040's prohibition on an associated person from participation "in any manner" in a private securities transaction without prior written notice to that person's employer. In In re Ronald J. Gogul, 52 S.E.C. 307 (1995), the representative argued that he did not sell the securities to the investors, but merely referred clients to the seller for the transactions. In holding that Gogul had violated Conduct Rule 3040 by participating in the sales of the securities by referring customers to the sellers, the Commission stated that Conduct Rule 3040:

> requires that an associated person give notice to the firm when participating "in any manner" in a private securities transaction outside the regular course of his association with the firm. The reach of [Conduct Rule 3040] is very broad. It covers an associated person who not only makes a sale but who participates "in any manner" in the transaction. We have previously held that a salesman who referred a customer to the issuer of a promissory note, and received a commission when the customer purchased the note, participated in a private securities transaction to an extent sufficient to subject him to the requirements of [Conduct Rule 3040]. Id. at 310. (Footnotes omitted).

See also In re Gilbert M. Hair, 51 S.E.C. 374 (1993) ("finder" who received referral fee for putting interested persons in touch with issuer of promissory notes held to have participated in securities transactions pursuant to Conduct Rule 3040).

In the recent case of In re Stephen J. Gluckman, Exchange Act Rel. No. 41628 (July 20, 1999), the respondent argued unsuccessfully that he had not engaged in private securities transactions, as defined in Conduct Rule 3040, because of his limited involvement in the securities transactions at issue. Gluckman argued that he could not be held liable because the purchasers' decisions to invest in the security were actually made as a result of representations made by third parties during meetings that Gluckman did not attend. The Commission rejected this argument:

> Gluckman's responsibility to give notice under Rule 3040 does not hinge on whether the investors also independently discussed and negotiated the transactions with Lucas. The reach of Conduct Rule 3040 is very broad, encompassing the activities of "an associated person who not only makes a sale but who participates 'in any manner' in the transaction." Id. at 8.

Thus, Goldsworthy's responsibility to give notice under Conduct Rule 3040 was not diminished by the fact that the investors independently discussed and negotiated the transactions with Ryan or others at Smith Barney, rather than with him. Conduct Rule 3040 is broadly construed to reach any participation in a transaction, including Goldsworthy's not insignificant participation in the SCF Note transactions at issue.

The record also shows that Goldsworthy did not give written notice of his sale of the SCF Notes to his employer, USSC. The Miranti Letter stated that Goldsworthy never received permission from USSC to solicit loans for SCF. More importantly, Goldsworthy admitted that he had not provided written notice of the 1993 transactions to USSC. Instead, Goldsworthy argued at the Initial Hearing and at the Remand Hearing that he had given USSC a copy of an unexecuted SCF promissory note about a year before the 1993 transactions at issue and that this was sufficient for compliance with Conduct Rule 3040. Goldsworthy also argued that USSC had notice of the transactions and cited in support of his position the testimony of James Villalobos ("Villalobos"), the Chairman of USSC, who stated that he did not recall receiving a written notice from Goldsworthy personally, but thought that Miranti was "aware" that Goldsworthy was using "promissory notes as a funding vehicle." We note that Villalobos also testified that he could not remember any specific conversation with Miranti concerning the notes. Moreover, even if Goldsworthy had given his member firm an example of a note, that would not have been sufficient notice under Conduct Rule 3040. Goldsworthy received "selling compensation" as defined by Conduct Rule 3040. Where selling compensation is received, prior written notice must be given for each transaction. In re William Louis Morgan, 51 S.E.C. 622, 627 (1993). The record is clear that no such notice was given prior to each of the transactions at issue.

Thus, the record supports the finding that Goldsworthy violated Conduct Rules 2110 and 3040 by participating in private securities transactions without the required notice to and approval from USSC.

Other Arguments Raised By Goldsworthy

Goldsworthy argues that since similar notes "were judged as non-securities" by various parties, including the NASD, in 1992, the SCF Notes sold to the 12 retail customers in 1993 could not have been securities. First, we note that there is no evidence in the record that anyone reviewed the notes in 1992 and concluded that they were not securities.[19] But even if this had happened, it would have no bearing on the charges at issue in this proceeding.

Goldsworthy asserts that the NASD made the determination that the 1992 notes were not a security because in a previous disciplinary matter (Complaint No. C05930077), he had been charged with violations of the prohibition against outside business activities, but not with private securities transaction violations. In that case, Goldsworthy, without admitting or denying the allegations, accepted and consented to the entry of findings by the NASD that he: (1) became registered as an investment advisor contrary to a policy of his employer member firm prohibiting such registration; (2) failed to update his Uniform Application for Securities Registration or Transfer ("Form U-4") to reflect as an

[19] Patricia Bourgeois ("Bourgeois"), the NASD staff examiner who conducted both examinations, testified that she did not make a determination as to whether any of the 1992 notes were securities. Andrew Favret ("Favret"), the enforcement attorney who was assigned to both an earlier complaint against Goldsworthy and to the Initial Hearing on the instant matter, testified that there was no determination "one way or the other" that the earlier notes were or were not securities.

outside business activity his organization of "St. Charles Funds, Inc."; and (3) opened an account in the name of St. Charles Funds, Inc. with Smith Barney without notifying his employer in writing and without informing Smith Barney in writing that he was affiliated with another member firm.

Goldsworthy's argument is meritless. This case is concerned only with the circumstances surrounding the 1993 sales of the SCF Notes to Ryan's retail customers. The transactions involving similar notes in 1992 are thus immaterial to this case. Moreover, under Reves, it is necessary to examine all of the factors discussed above, including the method of distribution and the motivations and expectations of the buyers, in order to determine whether a promissory note is a security. As the Supreme Court stated in Reves, it is almost a certainty that any instrument labeled "stock" is a security. See also Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). Promissory notes, on the other hand, are not so easily identified.

Goldsworthy also argues that certain unsigned form letters, which he asserted had been prepared for Smith Barney to send to SCF Note purchasers to show that SCF did not intend the notes to be securities, demonstrated that the SCF Notes were not securities. There is no evidence in the record that any of the SCF Note purchasers received any of these form letters. Thus, the customers' understanding of the transactions could not have been influenced by letters they did not receive. Further, the subjective intentions of SCF or Goldsworthy concerning the nature of the transaction are irrelevant except insofar as they may have been communicated to and understood by the SCF Note purchasers.[20]

Goldsworthy also claims that his reliance on counsel was not adequately considered in the Initial Hearing. He refers to a memorandum from his outside counsel which discussed raising "seed money" to start a new mutual fund. The memorandum explained that this is usually accomplished by issuing restricted shares to the initial investors, and in most respects, the seed money investors are just like any other shareholders in a fund. We first note that, as a defense, reliance on counsel is available only in situations involving scienter-based misconduct, and thus is inapplicable to this matter involving violation of the rules regarding private securities transactions. In re Gary E. Bryant, 51 S.E.C. 463, 468 at n. 22 (1993). For non-scienter-based misconduct, this argument may be raised as a mitigating factor in assessing sanctions, but only when certain elements are met. The "advice of counsel" defense requires that the applicant: (1) make a complete disclosure to the attorney of the intended action; (2) request the attorney's advice of the legality of the intended action; (3) receive counsel's advice that the conduct would be legal; and (4) rely in good faith on that advice. In re William H. Gerhauser, Sr., Exchange Act Rel. No. 40639, 12 at n. 26 (Nov. 4, 1998). There is no evidence that Goldsworthy ever asked any attorney to provide him with a written opinion on whether the SCF Notes were securities, and none of the attorney-prepared materials submitted in evidence by Goldsworthy dealt with this question or even

[20] Moreover, as a matter of law, Goldsworthy is presumed to know and understand the NASD Rules. Carter v. SEC, 726 F.2d 472, 474 (9th Cir. 1983). In particular, it is no defense that Goldsworthy may not have understood that the notes were securities. Cf. SEC v. Parkersburg Wireless Ltd. Liability Co., 991 F. Supp. 6, 9 (D.D.C. 1997) (that one “had no idea that the units he was selling were securities" is no defense to a charge of sale of unregistered securities).

suggested that an attorney had any knowledge that the notes were to be sold by Ryan to his retail customers. Accordingly, Goldsworthy has not shown that these standards were met in this action.

Goldsworthy asserts that the NASD erroneously is disregarding the corporate existence of SCF and improperly attributing the actions of SCF to Goldsworthy. We note, however, that Goldsworthy was charged in this proceeding because of his personal involvement in the SCF Note sales, and we hold that the fact that SCF, rather than Goldsworthy himself, was the issuer of the notes is irrelevant to the charges. Goldsworthy's personal involvement is evident from his receipt of a portion of the note proceeds. As discussed above, Goldsworthy admitted that he paid himself a salary from the note sale proceeds and also used some of the funds to pay his own NASD fine. Because he personally received a portion of the note sale proceeds, Goldsworthy is deemed to have received "selling compensation" as the term is defined in Conduct Rule 3040.

In In re William Louis Morgan, 51 S.E.C. 622 (1993), the Commission sustained the NASD's imposition of sanctions for private securities transactions without adequate notice as required by Conduct Rule 3040. The respondent in that case sold promissory notes for the purpose of financing his branch office operations and to meet personal expenses. He argued that a single notice he provided to his firm prior to beginning sales of the notes was sufficient compliance with the rule. Under Conduct Rule 3040, a single written notice may be provided when there is a series of related transactions involving no selling compensation. When selling compensation is involved, however, prior written notice must be provided for each transaction. Morgan argued that he did not receive selling compensation and thus that his activity fell under the single notice provision. The Commission disagreed, explaining that "selling compensation" is broadly defined to include any compensation paid directly or indirectly from any source in connection with or as a result of the purchase or sale of a security.

> It cannot be disputed that Morgan received value from the sales of the notes. The $368,000 in proceeds provided Morgan with cash, which Morgan used to finance his branch office operations and to fund his personal expenses. Thus, Morgan's sale of the notes clearly involved selling compensation. Morgan did not provide FAS with written notice prior to each of the five individual transactions. The letter did not even provide the names of the investors. Nor could it do so, since their names were not yet known even to Morgan.

Id. at 627.

As explained in Morgan, the payment of a portion of the note sale proceeds to Goldsworthy was "selling compensation" as the term is broadly defined in Conduct Rule 3040. Thus, Goldsworthy is a proper party respondent in this proceeding, and the fact that SCF was the obligor on the notes is irrelevant to the charges against Goldsworthy.

Conclusion

For all of these reasons, we find that Goldsworthy violated Conduct Rules 2110 and 3040 by participating in private securities transactions without giving prior notice to, and obtaining the approval of, USSC.

Sanctions

In imposing sanctions on Goldsworthy, we have considered that this is a very serious matter involving substantial losses totaling $499,744 incurred by 12 customers over a period of almost eight months. With respect to the principal considerations listed in the applicable sanction guideline,[21] we note that Goldsworthy was previously disciplined by the NASD for failing to update his Form U-4 to reflect his outside business activities, and failing to notify his member firm in writing that he had opened an account with another firm. He also pleaded guilty to charges of attempted theft and the sale of unregistered securities brought by the State of Louisiana. Goldsworthy was affiliated with the issuer as the President of the entity raising the money. Numerous transactions occurred, and Goldsworthy received significant compensation from offering proceeds. There is no evidence that Goldsworthy gave written or oral notice to USSC of any of these for-compensation transactions. Moreover, Goldsworthy refuses to accept responsibility for his actions and continues to assert that Smith Barney was at fault and that the State of Louisiana conducted unfair investigations into his activities and destroyed his business opportunities.

The applicable sanction guideline suggests consideration of a suspension for up to two years and notes, "[i]n egregious cases, consider barring individual." We conclude that a bar should be imposed because of the egregious nature of this case. In keeping with the policies on imposition of a censure and the imposition and collection of monetary sanctions set forth in NASD Notice to Members 99-59 (July 1999) and Notice to Members 99-86 (October 1999), we will not, however, censure Goldsworthy or impose monetary sanctions[22] upon him, except for the imposition of costs.

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[21] See NASD Sanction Guidelines (1998 ed.) at 15 (Private Securities Transactions).

[22] We note that except for BB, who has been receiving compensation from Goldsworthy pursuant to the Order issued in the Louisiana state court criminal case, the customers have received compensation from Smith Barney. We conclude that it is not appropriate in this case to order restitution to Smith Barney.

Accordingly, Goldsworthy is barred from association with any member firm in any capacity, and assessed costs of $2,502: $1,269.50 (the cost of the Initial Hearing Transcript), $932.50 (the cost of the Remand Hearing Transcript), and $300 in administrative costs. The bar is effective immediately upon the issuance of this decision.[23]

On behalf of the National Adjudicatory Council,

Joan C. Conley
Senior Vice President and Corporate Secretary

[23] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.