

BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of

District Business Conduct  
Committee For District No. 5

Complainant,

v.

John M.W. Crute, Jr.  
Ft. Stockton, Texas,

Respondent.

DECISION

Complaint No. C05950018

District No. 5

Dated: August 28, 1997

This matter was appealed by respondent John M.W. Crute, Jr. ("Crute") pursuant to NASD Procedural Rule 9310. For the reasons discussed below, we hold that Crute violated Article III, Sections 1 and 28 of the Association's Rules of Fair Practice (now and hereinafter referred to as Conduct Rules 2110 and 3050), and we order that he be censured; fined \$3,544.27; and assessed hearing costs of \$541.50.

Background. Crute entered the securities industry in 1964 as a general securities representative. From May 1991 through March 30, 1992, he was registered as a general securities representative and associated with J.C. Bradford & Co. ("J.C. Bradford"). From March 26, 1992 through July 5, 1995, he was registered as a general securities representative and associated with Capital Investment Group, Inc. ("Capital Investment"). Crute is currently not registered with the Association, nor is he associated with a member firm.

Facts

During the course of a routine examination of J.C. Bradford conducted in January 1994, the staff of NASD Regulation, Inc. District No. 5 reviewed certain underwritings in which J.C. Bradford had participated. As a result of this examination, District staff discovered that Crute, while registered with Capital Investment, had purchased shares of Rocky Shoes, a public offering stock that immediately traded at a premium in the secondary market ("hot issue").

A staff compliance specialist ("Examiner") testified that, during his review of Crute's account activity at J.C. Bradford, he discovered that in six instances Crute had purchased shares of hot issue stocks. The Examiner testified that there was a "total immediate profit" of approximately \$2,100 on these six transactions. The total immediate profit was computed based on the spread between the immediate aftermarket price of the initial public offering and the public offering price, multiplied by the number of shares. The actual profit realized by Crute on the six subject transactions was \$1,226.76. The six subject purchases occurred between February 3 and June 30, 1993, during which time Crute was registered with Capital Investment. Crute retired from J.C. Bradford on March 30, 1992, and his affiliation date with Capital Investment was March 26, 1992. The Central Registration Depository ("CRD") records reflected that Crute's termination from Capital Investment took place in July 1995. No one at Capital Investment was made aware of the six subject transactions.

In a written response to District staff's inquiry, Crute explained that he became affiliated with Capital Investment after he retired from J.C. Bradford. At that time, he had a contractual agreement not to compete with J.C. Bradford. According to Crute's response, "[a]dvice from brokerage friends suggested that [he] place [his] license with Capital in order to prevent its expiration [but he] did not at any time consider [himself] under the employment or obligation of Capital Investment Group." Crute explained at the DBCC hearing that because of a lawsuit filed against him by J.C. Bradford based upon the non-compete agreement in his employment contract, he told Capital Investment in April 1992 that he was not going to work there. He testified that he never transferred an account to, or put any orders in, at Capital Investment. Shortly after April 1992, Crute left North Carolina and pursued other business interests. According to Crute, J.C. Bradford must have known that he had moved his license to Capital Investment because J.C. Bradford initiated the lawsuit. Crute was aware of the policy at firms where he had been employed that a broker was restricted from purchasing hot issues. He did not think that there was a problem with the six transactions at issue because no one said anything to him.

## Discussion

Cause One. The first cause of the complaint alleged, and the DBCC found, that from February 3, 1993 through June 30, 1993, Crute, an employee of member firm Capital Investment, purchased stock in a total of six initial public offerings through member firm J. C. Bradford, for an account in which he had a beneficial interest. These purchases each involved hot issues. This conduct was alleged to have constituted separate and distinct violations of the Board of Governors' Interpretation with respect to Free-Riding and Withholding (now IM-2110-1) (the "Free-Riding and Withholding Interpretation") of Conduct Rule 2110. This Interpretation provides that it is a violation of Conduct Rule 2110 to fail to make a bona fide public distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins, regardless of whether such securities are acquired by the member as an underwriter, a selling group member or from a member participating in the distribution as an underwriter or selling group member, or otherwise. The Interpretation specifically provides that it is a violation of Conduct Rule 2110 for a member or

person associated with a member to continue to hold any of the securities so acquired in any of the member's accounts.

The purpose of the Free-Riding and Withholding Interpretation is to "ensure that NASD members and their associated persons make a bona fide distribution to the public of securities that are part of the public offering." In re First Philadelphia Corp., et al., 50 S.E.C. 360, 361 (1990). The Interpretation is designed to prevent restrictions on the supply of offerings that trade at an immediate aftermarket premium. Id.

In a free-riding case, it is "immaterial, except in connection with fixing the nature of the sanctions to be imposed in the public interest, whether [the respondent] was aware [he] was violating the NASD rules." In re Rothschild Securities Corp., et al., 45 S.E.C. 444, 446 (1974); see also In re First Philadelphia Corp., et al., 50 S.E.C. 360, 361-62 (1990) (rejecting arguments that would "read an element of scienter into a rule which is prophylactic in nature and does not require scienter to support a finding of violation" and noting that violations of the Interpretation "need not be intentional"). We find that even if at the time of the transactions at issue Crute did not think he was employed by Capital Investment, and thus thought that he was free to purchase a hot issue, he was actually still registered with the Association<sup>1</sup> and thus violated the Free-Riding and Withholding Interpretation. It is not necessary to find that Crute acted intentionally because even an inadvertent violation is sufficient to find that Crute violated Conduct Rule 2110.

The Securities and Exchange Commission ("the Commission") has held that proof of a violation requires a showing that the initial aftermarket activity was at a price higher than the offering price. In re Charles Martin Powell, 51 S.E.C. 601 (1993) (dismissing an NASD disciplinary action involving an alleged violation of the Free-Riding and Withholding Interpretation because the Commission was unable to determine from the record that the transactions were effected at a premium over the offering price and occurred at the opening of the market). After reviewing the record in this case, the NBCC issued an Order of Remand dated October 28, 1996. In that Order, the NBCC noted that other than a schedule prepared by staff, there was no evidence in the record of the initial public offering price or of the secondary market trading showing that the stocks at issue traded at a premium in the immediate aftermarket. The NBCC thus ordered the record to be supplemented on remand with evidence that the securities at issue traded at an immediate aftermarket premium. The NBCC also noted that other than this schedule prepared by staff, there was no evidence in the record that the "hot issue" securities were placed into an account in which Crute had a beneficial interest, nor was there evidence of the prices at which Crute bought and sold the securities. The NBCC also directed the DBCC to reconsider the sanctions in light of the NASD Sanction Guidelines ("Guidelines").

Pursuant to the Order of Remand, regional counsel supplemented the record with copies of account statements for Crute, dated January through July 1993, which demonstrated that the six

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<sup>1</sup> According to the CRD records, Crute was registered as a general securities representative with Capital Investment from March 26, 1992 through July 5, 1995. The hot issue purchases took place from February 3, 1993 through June 30, 1993.

securities purchases were made in Crute's account at J.C. Bradford. The regional counsel also supplemented the record with a revised schedule prepared by staff and with trade reports for five of the six subject securities showing inter-dealer trades during the first 15 minutes of trading on the first day of market trading for these initial public offerings. Crute stipulated to the entry of these exhibits into the record. On remand, the DBCC affirmed the sanctions it had previously imposed even though it recognized that the fine amount was slightly lower than that recommended by the applicable Guidelines.

According to the trade reports introduced into the record by staff, the first trade of the day for Rocky Shoes stock (symbol RCKY) on February 3, 1993 was at a price of \$12.25. Crute purchased Rocky Shoes stock at the initial public offering price of \$10 and sold it in the aftermarket at \$11.75. We find that Rocky Shoes was a hot issue purchased by Crute while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Harry's Farmer's Market stock (symbol HARY) on May 20, 1993 was at a price of \$19.25. Crute purchased this stock at the initial public offering price of \$17 and sold it in the aftermarket at \$19.25. We find that Harry's Farmer's Market stock was a hot issue purchased by Crute while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Regional Acceptance stock (symbol REGA) on June 8, 1993 was at a price of \$11. Crute purchased this stock at the initial public offering price of \$10 and sold it in the aftermarket at \$10.25. We find that Regional Acceptance stock was a hot issue purchased by Crute while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Sodak Gaming stock (symbol SODK) on June 30, 1993 was at a price of \$22. Crute purchased this stock at the initial public offering price of \$16 and sold it in the aftermarket at \$22. We find that Sodak Gaming stock was a hot issue purchased by Crute while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

According to the trade reports, the first trade of the day for Brock Candy stock (symbol BRCK) on March 12, 1993 was at a price of \$15.50.<sup>2</sup> Crute purchased this stock at the initial public offering price of \$14 and sold it in the aftermarket at \$14.75. We find that Brock Candy was a hot issue purchased by Crute while registered with the Association in violation of the Free-Riding and Withholding Interpretation.

The record does not contain a trade report for YPF Sociedad Anonima stock. Pursuant to the Commission's finding in Powell, supra, we find that there is insufficient evidence in the record to support a finding that this stock traded at a premium over the initial public offering price at the

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<sup>2</sup> The trade report shows the first trade of the day for Brock Candy stock on March 12, 1993 was at 15 128B. This means 15 128/256 or 15-1/2.

opening of the market and therefore was a hot issue. Accordingly, we dismiss the allegations of the complaint relating to YPF Sociedad Anonima stock.

Cause Two. The second cause of the complaint alleged, and the DBCC found, that Crute failed and neglected to notify his employer member firm Capital Investment in writing that he had established and maintained a separate securities account with J.C. Bradford. In addition, Crute failed and neglected to inform J.C. Bradford in writing of his association with Capital Investment. This conduct was alleged to have constituted separate and distinct violations of Conduct Rules 2110 and 3050. Conduct Rule 3050(c) provides that an associated person:

prior to opening an account or placing an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or her association with the other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both members in writing promptly after becoming so associated.

Consequently, pursuant to Rule 3050, Crute was required to notify J.C. Bradford in writing of his association with Capital Investment and was required to notify Capital Investment of the account he maintained at J.C. Bradford. Crute did not deny that he had never provided Capital Investment with written notice of his account at Bradford. Crute testified that he provided Capital Investment with verbal notice that he had an account at J.C. Bradford. The record is clear that no written notice was given by Crute to either J.C. Bradford or Capital Investment and we therefore affirm the DBCC's findings that Crute violated Conduct Rules 2110 and 3050 as alleged in the second cause of the complaint.

Sanctions. The DBCC imposed sanctions of a censure and a fine of \$4,126.76. This amount represents the actual profits earned by Crute on the alleged six hot issue transactions plus a \$2,500 fine. Since we are dismissing the findings with respect to YPF Sociedad Anonima stock, we reduce the fine amount by \$582.49, the actual profit earned by Crute with respect to this stock. We agree with the DBCC that sufficient mitigation exists to depart from the Sanction Guidelines,<sup>3</sup> which recommend a fine that includes transaction profit. Transaction profit is defined as the greater of the immediate aftermarket unrealized profit (the price determined to be the immediate aftermarket price times the number of shares minus the public offering price) or the actual profit realized. In Crute's case, the transaction profit would be greater than the actual profit realized. Crute, however, has had no prior disciplinary history for the past 30 years, the violation was inadvertent, and the amounts were minimal. We find that these are sufficient mitigating circumstances to base the fine amount on Crute's actual profits rather than the transaction profit.

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<sup>3</sup> See, Guidelines (1993 ed.) at 24 (Free-Riding and Withholding).

Accordingly, Crute is censured; fined \$3,544.27; and assessed hearing costs of \$541.50.<sup>4</sup>

On Behalf of the National Business Conduct Committee,

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Joan C. Conley, Corporate Secretary

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<sup>4</sup> 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.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will be summarily suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.