FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. JOSEPH A. PADILLA (CRD No. 2203872), and ANDREA M. RITCHIE, f/k/a ANDREA M. BRUNO,[1] (CRD No. 5060501), Respondents.	Disciplinary Proceeding No. 2006005786501 Hearing Officer – LBB **HEARING PANEL DECISION** October 18, 2010

Respondents Joseph A. Padilla and Andrea M. Ritchie violated NASD Conduct Rule 2110 by selling unregistered securities in violation of Section 5 of the Securities Act of 1933. For these violations, Respondents are suspended for six months from associating with any member firm in any capacity and fined $10,000 each. In addition, Respondents are ordered to disgorge all commissions earned from the unlawful sales of the securities that were the subject of the Complaint.

Appearances

For the Department of Enforcement, Helen G. Barnhill, Esq., Senior Regional Counsel, Denver, Colorado, and Mark J. Fernandez, Esq., Senior Regional Counsel, New Orleans, Louisiana.

For Respondents, Irving M. Einhorn, Esq., Manhattan Beach, California.

[1] Ms. Ritchie was formerly known as Andrea M. Bruno, prior to her marriage. The Complaint refers to her as Bruno, but Ms. Ritchie has changed her registration in the Central Registration Depository to use her married name. The caption of this case is changed to reflect the name change.

DECISION

I. Procedural Background

The Department of Enforcement ("Enforcement") filed the Complaint in this disciplinary proceeding on March 23, 2009, asserting two causes of action against Respondent Joseph A. Padilla, and one cause of action against Respondent Andrea M. Ritchie.[2] The First Cause of Action charges Padilla with violating NASD Conduct Rule 2110 by selling unregistered shares of VMT Scientific, Inc. ("VMT") in violation of Section 5 of the Securities Act of 1933.[3] The Second Cause of Action charges both Respondents with selling unregistered shares of five securities, thereby violating Section 5 and Conduct Rule 2110. Respondents filed their Answer on April 16, 2009, admitting that they sold unregistered securities, but asserting as an affirmative defense that their participation in the transactions was lawful under Section 4(4) of the Securities Act, the "brokers' exemption" to Section 5.

A hearing was held in Los Angeles, California, on March 16 – 18, and April 26, 2010, before a Hearing Panel comprised of a former member of the District 2 Committee, a former member of the District 5 Committee, and a Hearing Officer. Enforcement submitted its post-hearing brief on June 21, and Respondents submitted their post-hearing brief on July 16, 2010.

II. Summary of Findings and Conclusions

Respondents were in the business of liquidating unregistered securities. Section 5 of the Securities Act provides that, unless a registration statement is in effect or an exemption applies,

[2] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the NASD Conduct Rules that were in effect at the time of Respondents' alleged violations. The applicable rules are available at www.finra.org/rules.

[3] A violation of Section 5 of the Securities Act constitutes a violation of NASD Conduct Rule 2110. *See* footnote 24, *infra*.

it is unlawful to sell a security through the use of any means or instrumentality of transportation or communication in interstate commerce or of the mails. The Complaint focuses on the deposit and liquidation of six unregistered securities. There is no dispute that Respondents participated as brokers in the sale of the six securities, that the securities were not registered, or that interstate commerce was used. These facts are sufficient to establish a prima facie Section 5 violation. Thus, the focus of the hearing was the applicability of the brokers' exemption, as set forth in Section 4(4).

To qualify for the brokers' exemption, a registered representative who sells unregistered securities must, before executing the sale, take whatever steps are necessary to make certain that the transaction does not involve an issuer, a person in a control relationship with an issuer, or an underwriter.[4] Respondents sold millions of shares of six unregistered securities that were deposited by clients who claimed to be consultants, and who often quickly transferred many of the shares to other purported consultants who had recently opened accounts with Respondents. Many of the clients were call-ins or referrals, not previously known to Respondents. Under these circumstances, they should have engaged in a searching inquiry to determine whether the transactions they were asked to execute were links in an unlawful distribution. In fact, they did almost nothing to determine whether the distributions were lawful. Instead, they relied on their firms' compliance departments, the transfer agents, and the clearing firms to determine the lawfulness of the transactions. As discussed below, Respondents have failed to establish that

[4] Distribution by Broker-Dealers of Unregistered Securities, Exchange Act Rel. No. 6721, 1962 SEC LEXIS 74, at *3 (Feb. 2, 1962). "The term 'underwriter' is broadly defined in the Securities Act to include any person or entity that purchases securities from an issuer with a view to distribute, or offers or sells for an issuer in connection with a distribution, and any person or entity participating, directly or indirectly, in a distribution of securities. The term '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. *See* Sec. 2(a)(11), Securities Act of 1933. Whether a customer is acting as an underwriter, is a control person, or is acting on behalf of an underwriter or control person, depends on the particular facts and circumstances of the transaction." FINRA Reg. Notice 09-05, n.4.

they conducted the diligent inquiries required to avail themselves of the exemption under Section 4(4) of the Securities Act. In the absence of an exemption, Respondents' participation in the transactions violated Section 5 of the Securities Act and NASD Conduct Rule 2110.

III. Origin of the Investigation

The First Cause of Action arose out of a cycle examination of Empire Financial Group, Inc. ("Empire"), during which the examiner noticed sales of low-priced stocks with very little purchasing activity originating at Empire's Carlsbad, California branch office, where Padilla was located. Tr. 51-53, 225.[5] The Second Cause of Action arose out of a cycle examination of Cambria Capital Advisors, Inc. ("Cambria"). During that examination, the audit team noticed large blocks of securities coming into the firm, primarily though the Carlsbad branch, where both Respondents were located, and, shortly after receipt, being journalled to other accounts or liquidated. Tr. 303-304.

IV. Respondents

Respondent Joseph A. Padilla was first registered with FINRA as a General Securities Representative in February 1992. Padilla was associated with five member firms before associating with Empire in May 2005. He was registered through Empire as a General Securities Representative from May 25, 2005, until January 2007, when he became associated with Cambria. He was registered through Cambria as a General Securities Representative and a General Securities Principal from January 18, 2007, until June 26, 2007. He was registered through Scottsdale Capital Advisors from June 2007 until January 2008, left the industry for

[5] References to the exhibits provided by Enforcement are designated as "CX-___." References to the exhibits provided by Respondents are designated as "RX-___." The parties filed a brief set of unnumbered factual stipulations on March 11, 2010, references to which are identified as "Stipulation." References to the hearing transcript are designated as "Tr. ___." References to matters admitted in Respondents' Answer to the Complaint are designated as "Answer ¶ ___."

about a year, and has been re-registered with that firm since January 2009. Answer ¶ 2; CX-1; Tr. 740-741.

Respondent Andrea M. Ritchie was first registered as a General Securities Representative in February 2006.[6] She was registered with Cambria as a General Securities Representative from December 11, 2006, through May 7, 2007, and as a General Securities Principal from April 30, 2007, through May 7, 2007. Answer ¶ 3; CX-2. Ritchie is currently registered with FINRA through Scottsdale Capital Advisors. Answer ¶ 3; CX-2.

While associated with Empire and Cambria, both Padilla and Ritchie worked out of an office in Carlsbad, California. Padilla and Ritchie conducted business jointly at Cambria from January 12, 2007, until May 7, 2007. Padilla retained 96% of the net commissions they received, and he paid Ritchie 4% of the net commissions. Ritchie viewed Padilla as her partner and employer. Answer ¶ 10; CX-143; Tr. 810.

Respondents' main business was the receipt and liquidation of Pink Sheet and bulletin board stocks. Padilla testified that this was 90% of his business, and that they did hundreds of such transactions each week. He sought out clients who were paid in stock rather than cash. During the period relevant to the charges in the Complaint, Respondents were the only registered persons at the Carlsbad branch. They were supervised out of the firm's home office. Tr. 52, 316, 648, 664-665, 678, 683-684, 811; *see* Answer ¶ 4.

V. Respondents' Sales of Unregistered Securities

Padilla is charged with the unlawful sale of unregistered securities of one issuer while he was associated with Empire, and both Respondents are charged with the unlawful sale of unregistered securities of five issuers while they were associated with Cambria.

[6] In February 2006, upon becoming registered as a General Securities Representative through Empire, Ritchie began working with Padilla and assisting him with transactions in his customer accounts. Answer ¶ 5. The Complaint does not charge Ritchie with any violations during her tenure at Empire.

A. Padilla's Sales of Unregistered VMT Stock While at Empire

From October 21, 2005, through June 5, 2006, Padilla accepted and executed orders for the sale of approximately 6,389,033 shares of VMT common stock into the market for total proceeds of $1,392,709. Answer ¶ 16.[7] Padilla received approximately $53,312 in net commissions from sales of VMT. Answer ¶ 17. VMT was a thinly traded Pink Sheet stock. Tr. 77-78, 82; CX-67; CX-68. The VMT shares were not registered pursuant to Section 5 of the Securities Act of 1933. Answer ¶ 18; Stipulation.

1. Initial Deposits of Unregistered VMT Stock into Accounts of Entities Owned and Controlled by S.D.

On or about June 14, 2005, S.D. opened an account with Empire for C.A.G.I., a company that S.D. owned or controlled. Padilla was the Empire representative on the account. Answer ¶ 12. According to C.A.G.I.'s new account form, the company was a consultant. S.D. signed the new account form as president, secretary, and treasurer. CX-42. Although there is no direct evidence of the nature of C.A.G.I.'s consulting business, Padilla described another of S.D.'s businesses as "investor awareness," and helping companies raise capital. Tr. 702.

From about October 7, 2005, through December 8, 2005, C.A.G.I. transferred 8,111,269 shares of VMT common stock into its account at Empire. Most of the shares were transferred electronically from World Trade Financial, another brokerage firm. Physical certificates were delivered for 1.2 million of the shares. Answer ¶ 13; CX-64; Tr. 63, 256. Padilla did not know how S.D. had obtained the VMT shares. Tr. 702.

S.D. opened an account for M.C.G., purportedly another consulting firm, on December 20, 2005. S.D. was identified in the new account documents as the chairman, president, and

[7] On its website and in press releases in November 2005, VMT claimed to have patented breakthrough technology for treatment of vascular problems associated with diabetes. CX-28; Tr. 276, 290. The press releases indicate that the product had not yet been marketed. CX-28.

secretary of M.C.G. CX-43. On about December 23, 2005, 2.5 million shares of VMT were deposited into M.C.G.'s Empire account by delivery of a physical certificate. CX-18; CX-24; Tr. 185-186.

S.D. provided corporate resolutions for one of the C.A.G.I. certificates and for the M.C.G. certificate. The corporate resolutions both stated that the respective certificates were "validly issued as indicated on its face, there are no adverse claims pertaining to this certificate and the shares are free trading and will not be retracted at a later date." There was no information concerning the reason for the issuance of the certificate, whether there was consideration paid, or the basis for the statements in the resolutions. CX-23; CX-24. No corporate resolutions were provided for the other two certificates deposited in the C.A.G.I. account because they did not reach the size thresholds established by Empire. Tr. 714-715, 721-722.

2. Journal Transfers and Sales of Unregistered VMT Stock from Entities Controlled by S.D.

a) Sales of VMT Stock by C.A.G.I.

Padilla executed sales of 4,290,533 of the VMT shares deposited by C.A.G.I. at Empire from October 21, 2005, through June 5, 2006, for $935,236. Answer ¶ 16.

b) Transfers of VMT by C.A.G.I. to S.M., and Sales by S.M.

S.M. opened an account with Padilla at Empire on about July 20, 2005. The new account form stated that S.M. was a call-in, not previously known to Respondent. According to the new account documents, S.M. was in the business of investing. CX-44. Between November 22, 2005, and December 6, 2005, S.D. made three transfers of VMT common stock from C.A.G.I.'s Empire account to S.M., totaling 2,000,000 shares. Answer ¶ 14(b), (d), (f); CX-42. The letter acknowledging receipt of the third transfer stated that it was for consulting services, but no

reason was stated for the others. Answer ¶ 14; CX-42. S.M. sold 600,000 VMT shares from November 30, 2005, through December 7, 2005, for $262,342. Answer ¶ 16.

c) Journal Transfers of VMT by C.A.G.I. to M.C.H., and Sales by M.C.H.

M.C.H. opened an account with Padilla at Empire on about November 30, 2005. The new account information identified the company's business as investing. CX-45. The new account form stated that M.C.H. was a call-in, not previously known to Respondent. CX-45. On or about December 6, 2005, S.D. transferred 100,000 shares of VMT common stock from C.A.G.I.'s account at Empire to the account of customer M.C.H. at Empire. Answer ¶ 14(g). CX-45. The purpose of the transfer was consulting services. Answer ¶ 14. M.C.H. sold 100,000 shares of VMT on December 13, 2005, for $23,500. Answer ¶ 16.

d) Journal Transfers of VMT by C.A.G.I. to J.R., and Transfer by J.R.

J.R. opened an account with Padilla at Empire on November 9, 2005. CX-46. According to the new account documents, Respondent did not know J.R., who was introduced to Padilla by S.D. CX-46; Tr. 119-120. On November 10, 2005, S.D. asked Padilla to transfer 150,000 shares from C.A.G.I. to J.R. for consulting services. CX-42 at 22. Before he received the shares, J.R. asked to have the shares sent electronically to his account at a different brokerage firm. S.D. transferred the shares to J.R. on November 11, 2005. The shares were soon electronically transferred out of J.R.'s Empire account to J.R.'s account at the other brokerage firm. CX-46; CX-64; Tr. 65.

e) Journal Transfers of VMT by C.A.G.I. to K.A.I.; Sales and Journal Transfers of Shares by K.A.I.; and Disposition by Transferees from K.A.I.

K.A.I. opened an account with Respondent at Empire on about May 25, 2006. K.A.I. represented that it was in the business of consulting. CX-47. On October 24, 2005, 750,000

shares of VMT common stock were transferred from C.A.G.I.'s account at Empire to K.A.I.'s account. Answer ¶ 14(a). On November 23, 2005, 600,000 shares of VMT common stock were transferred from C.A.G.I.'s account to K.A.I.'s account. Answer ¶ 14(c). The reason given for the transfers was consulting services. Answer ¶ 14; CX-42.

K.A.I. sold 698,500 shares of VMT from October 31 through December 8, 2005, for $152,273. Answer ¶ 16. In addition to these sales, as discussed below, K.A.I. transferred a substantial number of VMT shares to other alleged consultants.

(i) Subsequent Journal Transfers from K.A.I. and Disposition by Transferees

- **Transfer from K.A.I. to F.F.R. and Transfers by F.F.R.**

F.F.R. opened an account with Respondent at Empire on about July 12, 2005. According to the new account documents, Respondent was introduced to the account by J.S.[8] CX-51. On November 1, 2005, K.A.I. requested a transfer of 150,000 shares of VMT from K.A.I.'s Empire account to F.F.R. for consulting services. CX-51 at 9. The shares were journalled to F.F.R. on November 4. CX-64; Tr. 65.[9] 100,000 shares were journalled to S.S. for consulting services on November 8, and the balance were transferred to F.F.R.'s account at another brokerage firm on December 1, 2005. CX-64; CX-51 at 11, 13.

- **Transfer to E.C.C. and Sale by E.C.C.**

E.C.C. opened a new account with Respondent on May 26, 2005. The new account form described E.C.C.'s business as consulting. CX-54.[10] On November 28, 2005, 250,000 shares of

[8] J.S. was not otherwise identified at the hearing.

[9] K.A.I. requested the transfer of another 50,000 shares on November 4, 2005. CX-47 at 12. However, the evidence showed the transfer of only 150,000.

[10] The information on how long Respondent had known E.C.C. or how the client became known to Respondent was not provided on the form.

VMT were transferred by journal entry from K.A.I. to E.C.C. The reason given for the transfer was consulting services. CX-54; CX-64; Tr. 65. E.C.C. sold 250,000 shares of VMT for $54,500 between November 28 and December 9, 2005. Answer ¶16.

- **Transfer to J.S. and Sale by J.S.**

J.S. opened an account with Respondent at Empire on May 25, 2005. According to the new account form, someone had introduced J.S. to Respondent a week earlier. No business or profession was identified. CX-52. J.S. received 250,000 shares of VMT on October 28, 2005, by journal transfer from K.A.I. Tr. 65; CX-64. J.S. sold 250,000 shares of VMT between November 8 and November 29, 2005, for $54,500. Answer ¶ 16.

- **Transfer to J.P.**

J.P. opened an account with Respondent on October 3, 2005. According to the new account documentation, Respondent had just met J.P. He had been introduced by B.P., from K.A.I. J.P. was a self-employed journalist. On November 1, 2005, K.A.I. transferred 1,500 shares to J.P. for consulting services. CX-53; CX-64.

f) Journal Transfers of VMT Stock from C.A.G.I. to P.B., and Sale by P.B.

P.B. opened a new account with Padilla at Empire on about November 22, 2005. P.B. was a golf caddie whom Respondent had not known previously. He had been introduced to Respondent by K.D., the brother of C.A.G.I.'s S.D. CX-48. From December 5 to December 15, 2005, S.D. transferred 200,000 shares of VMT common stock from C.A.G.I.'s account at Empire to P.B.'s Empire account. Answer ¶ 14(e), (h), (i). All of the transfers were allegedly for consulting services. Answer ¶ 14. P.B. sold 200,000 shares of VMT between December 8, 2005, and February 10, 2006, for $28,295. Answer ¶ 16.

g) Journal Transfer of VMT Stock from C.A.G.I. to S.I.H., and Transfer Back to C.A.G.I.

S.I.H. opened an account with Respondent at Empire on October 31, 2005. S.I.H. represented that its business was consulting. CX-50.[11] On January 4, 2006, S.D. asked Empire to transfer 350,000 shares of VMT from C.A.G.I.'s account to S.I.H.'s account for consulting services. CX-50 at 7. The shares were journalled on January 13, 2006. CX-64. Within three weeks, the shares were transferred back to C.A.G.I. for cancellation of a contract. CX-50 at 8; CX-64.

h) Journal Transfer of VMT Stock by C.A.G.I. to Liquid Assets Group, and Transfer Back to C.A.G.I.

On May 25, 2005, prior to joining Empire, Respondent Ritchie opened an account for her company, Liquid Assets Group, with Padilla at Empire. The new account documents stated that Liquid Assets Group was in the business of consulting, and that Ritchie was the sole officer. CX-49. On January 4, 2006, C.A.G.I. asked Padilla to transfer 40,000 shares of VMT to Liquid Assets Group, for consulting services. CX-49. The shares were transferred on January 17, 2006. CX-64. Pursuant to a request by Liquid Assets Group, the 40,000 shares were transferred back to C.A.G.I. on February 6, 2006. CX-64.

i) Journal Transfer of VMT Stock by M.C.G. to C.E.G.

C.E.G. opened an account at Empire on about December 12, 2005. According to the new account documents, the company had been formed to engage in the business of commerce. CX-55. The account was a call-in, previously not known to Padilla. CX-55 at 4. On January 17, 2006, 315,000 shares of VMT were transferred from M.C.G. to C.E.G. for consulting services. CX-43.

[11] The sections on the new account form for how, and how long, the client had been known to the broker were left blank. CX-50.

B. Respondents' Sales of Unregistered Securities While at Cambria

In the third quarter of 2006, Ritchie and Padilla decided to end their association with Empire and to associate with Cambria. Ritchie registered with Cambria first, so she and Padilla could evaluate how Cambria's back office and compliance procedures worked before Padilla committed to transferring all of his client accounts to Cambria. Upon joining Cambria, Ritchie began to handle the transfer of Padilla's accounts to Cambria and to handle orders placed by Padilla's clients. They intended that Padilla also would become registered with Cambria once they determined that the firm could accommodate their business. Answer ¶ 6.

Padilla moved to Cambria and became a manager for the office of supervisory jurisdiction in Carlsbad in January 2007. Ritchie reported to Padilla and to Cambria's compliance officer. Many of Respondents' customers at Cambria had been Padilla's customers at Empire. Answer ¶ 9.[12]

1. Sales of Unregistered First Pet Life, Inc. Stock

H.M. opened an account with Cambria on December 12, 2006. On December 13, 2006, H.M. opened an account for E.S.G.G., a company of which H.M. was the sole officer. Ritchie was the Cambria representative for both accounts. According to the new account applications, H.M.'s occupation was consulting. CX-69; Answer ¶ 21.

[12] Ritchie was at Cambria for about a month before Padilla moved to the firm. Ritchie was responsible for orders executed at Cambria's Carlsbad branch before Padilla joined the firm. CX-1; CX-2; Tr. 806-807. When Padilla moved to Cambria, the records did not adequately or accurately reflect whether Padilla or Ritchie was responsible for specific transactions. Tr. 329-332. Respondents did not keep records showing which of them took particular orders, and Respondents explained that, where records existed, the records might not accurately reflect which of them actually executed the order. Tr. 333-335, 808-809. The Hearing Panel finds that Respondents conducted their business jointly, so their failure to maintain accurate records on their responsibilities for specific companies is not material for purposes of this decision.

On December 14, 2006, H.M. caused E.S.G.G. to transfer electronically 29,767,000 shares of First Pet Life stock from an account at Empire into E.S.G.G.'s Cambria account.[13] On December 19, 2006, H.M. electronically transferred 11,975,000 shares of First Pet Life stock from his individual account with Empire into his individual Cambria account. Answer ¶ 22; CX-72; CX-76 at 20; CX-83 at 12; CX-153. First Pet Life securities were not registered pursuant to Section 5 of the Securities Act of 1933. Stipulation. It was a thinly traded Pink Sheet stock. Tr. 344, 421; CX-71.

On January 12, 2007, R.D. opened an account at Cambria. Respondents were the representatives for the account. On January 24 and February 5, 2007, E.S.G.G. transferred a total of 5,000,000 shares of First Pet Life to R.D.'s account at Cambria. According to the letters of authorization requesting the transfers, the reason for the transfers was consulting services. Answer ¶ 23. Respondents thereafter accepted and executed orders for the sale into the market of 41,742,000 First Pet Life shares for H.M., E.S.G.G., and R.D., for $40,982. Answer ¶ 23; Tr. 380-387, 421. Respondents received approximately $1,888 in net commissions from the sales of First Pet Life. Answer ¶ 24.

2. Sales of Unregistered Sustainable Power Corp. Stock

December 20, 2006, J.D. opened an account with Cambria. Ritchie was the Cambria representative for the account. On February 26 and March 2, 2007, J.D. deposited two certificates for Sustainable Power Corp., for 10,790,000 shares in total. Answer ¶ 25.[14] The

[13] First Pet Life claimed to be "a pet industry marketing company that [was] positioning itself to offer many services, including pet health insurance, pet supplies, along with boarding and grooming services nationwide." According to its financial statement, there was substantial doubt about its ability to continue as a going concern. CX-70.

[14] Sustainable Power issued a press release on February 20, 2007, announcing the commencement of trading in Sustainable Power stock. The release stated that the company was a division of U.S. Sustainable Energy ("USSEC"), and "assumes the role of worldwide marketing for turnkey power plant solutions that will utilize USSEC's biofuel discovery as the exclusive fuel source." CX-96.

Sustainable Power shares were not registered pursuant to Section 5 of the Securities Act of 1933. Stipulation; Answer ¶ 25. Sustainable Power was a newly issued Pink Sheet stock. Tr. 474, 480-481; CX-96. Between March 1 and March 30, 2007, Respondents accepted and executed orders from J.D. for the sale of 1,102,700 shares into the market through Cambria, generating proceeds of $225,000 for the J.D. account. Respondents jointly received $6,600 in net commissions as a result of J.D.'s sales. Answer ¶ 25.

3. Sales of Unregistered Pearl Asian Mining Industries Stock

On December 8, 2006, M.B. opened an account in the name of B.F.I. with Cambria. Ritchie was the Cambria representative for the account. On December 12, 2006, B.F.I. received certificates representing 1,075,000,000 shares of Pearl Asian Mining Industries, Inc. ("PAM") for deposit into its Cambria account.[15] The PAM shares were not registered pursuant to Section 5 of the Securities Act of 1933. Answer ¶ 26; Stipulation. PAM was a Pink Sheet stock. Tr. 426-428; CX-89.

On December 11, 2006, a law firm that represented B.F.I. faxed to Padilla at Empire a copy of a letter that the law firm had previously sent to the transfer agent for PAM. The letter acknowledged receipt of a corporate resolution from PAM stating that shares were free trading. M.B., the name partner in the law firm, was the account holder for B.F.I. Answer ¶ 26; RX-5; Tr. 708-709. Padilla testified that he obtained a purchase agreement for PAM when compliance asked for more information. Tr. 762. There is no corroborating evidence that such an agreement

[15] Pearl Asian Mining purported to be a mining company, engaged in gold and silver mining. It had minimal revenues in the first quarter of 2007, operating at a loss. CX-90.

was obtained, and there is no evidence of what the agreement said, or even of who the parties to the agreement were.[16]

Between December 12, 2006, and March 28, 2007, Respondents accepted and executed orders to sell 1,002,771,000 shares of PAM from the B.F.I. account, generating gross proceeds for the account of approximately $525,600. Respondents jointly received net commissions of approximately $15,000 from these sales. Answer ¶ 26.

4. Sales of Unregistered eHolding Technologies Stock

On January 26 and 27, 2007, L.T., E.T., and R.B. opened accounts at Cambria. Respondents were the Cambria representatives for the accounts. All three clients had the same mailing address, the same permanent street address, and the same business telephone and fax numbers. Each of the three accounts received certificates for the same number of eHolding Technologies, Inc. shares for deposit on the same dates.[17] Each of the three accounts received a total of 91,333,333 shares from February 2 to March 5, 2007. Answer ¶ 27; CX-148A; CX-103; CX-106. The eHolding shares were not registered pursuant to Section 5 of the Securities Act of 1933. Answer ¶ 29; Stipulation; CX-148A; Tr. 435-437, 453-456. eHolding was a Pink Sheet stock. Tr. 441, 461-463; CX-111.

The three customers then made journal transfers of eHolding shares to other Cambria accounts. Specifically, L.T. transferred a total 30,898,334 eHolding shares to the account of G.G. on February 7 and March 2, 2007; E.T. transferred 26,768,333 eHolding shares to the account of G.G. on March 2, 2007; and R.B. transferred 33,333,333 eHolding shares to the

[16] Padilla's testimony that he remembers receiving the agreement is not credible in light of both Respondents' testimony, discussed below, that they do not remember the transactions that are the subject of this matter, and the fact that neither Enforcement nor Respondents introduced the alleged agreement into evidence.

[17] As of April 18, 2007, eHolding described itself as a developmental stage company in the process of raising capital to install its first laminating facility. It had no revenues as of that date. CX-104.

account of J.L. on March 2, 2007. The letters of authorization for the transfers by E.T. and R.B. stated the reason for the transfers as payment for services. Answer ¶ 28; CX-148A.

Between February 14, 2007, and March 20, 2007, Respondents executed orders for the sale of 257,146,000 shares of eHolding into the market for L.T., E.T., R.B., J.L., and G.G. These sales generated gross proceeds for the accounts of $246,000 and net commissions for Respondents of $9,800. Answer ¶ 29; CX-148A.

5. Sales of Unregistered Aladdin Trading Stock

On December 8, 2006, B.T.F., R.T.I., and J.W. opened accounts with Cambria. On December 11, 2006, M.M. opened an account with Cambria. On December 13, 2006, R.P. opened an account with Cambria. Ritchie was the Cambria representative for these accounts. Answer ¶ 30. According to the new account applications, B.T.F., R.T.I., and M.M. were consultants; J.W. was employed by a car dealership; and R.P. was the owner of a seafood company. CX-134.

Between December 11 and December 18, 2006, a combined total of 25,000,000 shares were electronically received into these five customer accounts from Aladdin Trading & Company's transfer agents.[18] Answer ¶ 30; CX-147; Tr. 571. The Aladdin shares were not registered pursuant to Section 5 of the Securities Act of 1933. Stipulation. Aladdin was a thinly traded Pink Sheet stock. Tr. 566, 569; CX-102.

J.W., M.M., and B.T.F. made journal transfers of large blocks of Aladdin shares to the accounts of other Cambria customers within days of receipt. Specifically,

- On December 12, 2006, J.W. transferred 2 million shares to B.I. Answer ¶ 31; CX-147.

[18] Aladdin described itself as a "fine craft beer and ale importer." For the quarter ended June 30, 2007, the company reported revenues of $158,326, but was operating at a loss. CX-132.

- On December 14, 2006, M.M. transferred 3 million shares to B.I. Answer ¶ 31; CX-147.
- On December 21, 2006, B.T.F. transferred 3,833,333 shares to B.F.I. pursuant to a Stock Sale Agreement. Answer ¶ 31; CX-147.

Between January 18 and January 30, 2007, B.I. transferred 811,000 shares to ten other Cambria accounts. The reason listed for the transfers was marketing and consulting services. Two of the accounts, after receiving the shares, transferred them back to B.I. by journal entries. Three of the accounts that received the shares from B.I. transferred some or all of the shares they received to five other Cambria accounts. As a result of 25 journal transactions among Cambria customer accounts, 16 customer accounts held Aladdin shares originating with the 25,000,000 shares initially received into the five customer accounts described above. Answer ¶ 32; CX-147. Most of the letters of authorization requesting the transfers among the various accounts listed the reason for the transfers as consulting services. The other reasons given for the transfers were cancellation of a contract, purchase, money owed, and transfer between a corporate account and a personal account. CX-129; RX-2.

Between December 12, 2006, and March 30, 2007, Respondents accepted and executed orders to sell a net total of 1,410,000 Aladdin shares for their customers, generating proceeds of $524,300. Stipulation. Respondents jointly received net commissions of $38,900 as a result of these liquidations. Stipulation.

C. Respondents' Procedures for Sales of Unregistered Securities

Respondents testified that they did not remember any of the sales transactions that are the subject of the Complaint. Tr. 677, 799-800. They explained their lack of recollection by emphasizing the large number of clients they had and the large number of transactions they executed. Padilla testified that he had more than 1,000 customer accounts, and that Respondents executed 300 to 500 transactions in a typical week. Tr. 664-665, 678. Thus, rather than describe

the inquiries they made with respect to the transactions that are the subject of the Complaint, Respondents testified concerning how transactions were typically handled.[19]

When their firms received securities electronically, Respondents did no investigation. Rather, they informed their compliance departments that securities would be received by electronic transfer, and assumed that their compliance departments would perform an appropriate review. Tr. 571, 660-662, 845-846.

If Respondents received a certificate at Empire or Cambria, Padilla would check to see if it had a restrictive legend on it. If it had a restrictive legend, which he regarded as the equivalent of being potentially subject to SEC Rule 144, he knew that additional documentation was required.[20] Padilla only looked at the percentages of total outstanding shares represented by the stock being deposited if there was a legend on stock certificate, i.e., if it was "144 stock." Tr. 733, 791-792. If there was no restrictive legend on a certificate, Respondents sent it to their compliance department at their firms' home offices or directly to the clearing firm with a copy to compliance for its approval. Respondents typically sent certificates by overnight mail. Tr. 650-651, 654, 733, 746, 791-792, 809, 812. Respondents never conducted any research concerning issuers. Tr. 812, 814-815.

For journal transfers between customers, the transferring customer had to submit a signed, notarized letter of authorization, and the receiving party had to submit an acceptance letter. Tr. 669. As noted above, almost all the letters merely stated that the shares were being transferred for consulting services, with no further explanation. Respondents did not ask their

[19] Padilla testified that the procedures followed at Empire and Cambria were generally the same. Tr. 649, 656. To the extent there are any relevant differences, they are discussed herein.

[20] SEC Rule 144 creates a "safe harbor" with respect to the sale of unregistered securities by limiting the definition of the term "underwriter" to exclude those who meet the requirements of the Rule. Preliminary Note to Rule 144, 17 C.F.R. § 230.144; *Rodney R. Schoemann*, Exchange Act Rel. No. 9076, 2009 SEC LEXIS 3939, at *24-25, n.19; *SEC v. Sierra Brokerage Services Inc.*, 608 F. Supp. 2d 923, 944 (S.D. Ohio 2009), citing *SEC v. M & A West Inc.*, 538 F.3d 1043, 1050 (9th Cir. 2008).

customers the nature of their consulting work until about March 2007, when Cambria's compliance officer began to require Respondents to obtain copies of consulting agreements. *See* Tr. 669-671, 681, 796-797, 820-821. Two transfers of Aladdin shares were effected in March 2007, but all of the other journal transfers occurred before that date. There is no evidence that this procedure was used for any of the transactions in the Complaint other than the uncorroborated testimony that the procedure started during that month. There were no consulting agreements offered in evidence during the proceeding.

Respondents emphasized their deference to their compliance departments, both to tell them when information was required and to conduct any necessary investigations. However, Respondents had very little idea what procedures were followed by their firms' compliance departments. Respondents viewed their role as assisting their compliance departments in getting whatever information the departments deemed necessary. Tr. 657, 660-662, 793, 812. Padilla testified, "I always had a habit of just relying on my compliance. They knew more of the rules and laws more than I did, way more than I did. So I kind of always relied on our compliance department to handle that, and when they always asked for more docs, I did hand them more docs." Tr. 762.

Respondents testified that when they received certificates they would sometimes obtain certain types of documents, typically at the request of their compliance departments. Tr. 650-651, 792-793. Compliance sometimes wanted a letter from an issuer or a corporate resolution that said the stock was validly issued, not restricted, had no holds, would not be retracted at a later time, and had no adverse claims against it. Tr. 400, 651-652. Padilla testified that for deposits of certificates for more than 1 million shares or $500,000 in value, Empire required a corporate resolution saying that the shares could be freely traded. Respondents testified that they

obtained corporate resolutions for larger transactions, and either they or their firms received corporate resolutions for the two largest certificates for VMT and for the PAM certificate. Tr. 713-715, 720-723, 761-762; CX-23; CX-24; RX-6. When certificates were received, Cambria required Respondents to obtain a letter from the transfer agent or the issuer stating that the certificate was free trading and validly issued. Tr. 816. On occasion, a legal opinion was used instead of a letter from the issuer or the transfer agent. Tr. 817. Padilla claimed that he "had a habit" of calling customers who deposited a certificate for a large block of securities to ask them how they had obtained their shares, but did not document these alleged inquiries. Tr. 726-727.[21] Padilla did not testify that he made any such inquiries with respect to deposits of certificates for the six securities at issue. Other than this alleged habit, there is no evidence that Respondents made any inquiries concerning any of the six securities at issue.

Ritchie testified that transactions were often reviewed by outside lawyers retained by their firms. They were aware of the retention of outside counsel because Respondents reimbursed their firms for the legal expense. Tr. 798, 846-848. Respondents offered no other evidence concerning who the law firms were, which transactions they reviewed, the information that was provided to the law firms, or what advice, if any, was rendered by the law firms.

In March 2007, Cambria's compliance department began to use a "large block questionnaire" to obtain information about transactions. There was no specific size of transaction that triggered its use. It was used when the firm's compliance officer requested it. Tr. 656, 719, 723, 819. Ritchie testified that she did not ask customers where stock came from until she started using the questionnaire. Tr. 819-820. If the large block questionnaire was used

[21] FINRA has emphasized the importance of documenting information obtained in determining whether an unregistered security may be sold lawfully. "We find that the facts of this case should have caused the respondents to undertake a thorough and well-documented investigation to ensure that the stock was in fact exempt from registration, an obligation they failed to satisfy." *Dist. Bus. Conduct Comm. v. Orion Securities, Inc.*, No. C8B920007, 1993 NASD Discip. LEXIS 276, at *57 (N.B.C.C. Apr. 2, 1993).

during the time period of the last few transactions in the Complaint, there is no evidence that the questionnaire was used for any of those specific transactions. There were no large block questionnaires offered in evidence during the proceeding.

Respondents testified that they also relied on clearing firms and transfer agents to determine if a stock was freely tradable. Respondents had little or no idea what procedures were followed by the transfer agents and clearing firms. Padilla testified, "I relied on the job of the clearing house and the transfer agent to do their job, why we pay them to do what we had to do. It wasn't my job description to investigate any further than that or hire a private investigator for every cert[ificate] I had." Tr. 775; *see also* Tr. 657-658, 794. Ritchie testified that she never took any steps to determine if stocks were restricted. She testified that the transfer agent should know if the shares were restricted, and the transfer agent would rely on the clearing firm and DTC. Tr. 814.

VI. Respondents Violated NASD Conduct Rule 2110 by Selling Unregistered Securities in Violation of Section 5 of the Securities Act

Respondents have not genuinely contested that Enforcement has established a prima facie case of a violation of the Securities Act, but claim that the transactions were exempt under Section 4(4), the "brokers' exemption," which exempts brokers from liability if they can show that they performed an adequate inquiry to determine whether the sales were lawful. Respondents failed to establish the applicability of the brokers' exemption. Accordingly, the Hearing Panel finds that Respondents sold unregistered securities in violation of Section 5 of the Securities Act of 1933, thereby violating NASD Conduct Rule 2110.

A. The Evidence Establishes a Prima Facie Case of a Violation of Section 5 and Rule 2110 for Both Causes of Action

1. Elements of a Prima Facie Case

Section 5 of the Securities Act provides that, unless a registration statement is in effect or an exemption applies, it is unlawful to sell a security through the use of any means or instrumentality of transportation or communication in interstate commerce or of the mails.[22] The purpose of the registration requirements is to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[23] A violation of Section 5 of the Securities Act constitutes a violation of NASD Conduct Rule 2110.[24]

To establish a prima facie case of a violation of Section 5, Enforcement must show that (1) no registration statement was in effect as to the securities; (2) Respondents sold the securities; and (3) interstate transportation or communications were used in connection with the sale.[25] A showing of scienter is not required because "[t]he Securities Act of 1933 imposes strict liability on sellers of unregistered securities."[26]

The prohibitions in Section 5 extend not only to those who engage in the actual sale of securities, but also to those who engage in significant steps in the distribution process. Anyone

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[22] 15 U.S.C. § 77e(a) and (c); *see also Schoemann*, 2009 SEC LEXIS 3939, at *20-21; *Jacob Wonsover*, Exchange Act Rel. No. 41123, 1999 SEC LEXIS 430, at *15-16 (Mar. 1, 1999), *aff'd*, 205 F.3d 408 (D.C. Cir. 2000).

[23] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

[24] *Alvin W. Gebhart*, Exchange Act Rel. No. 53136, 2006 SEC LEXIS 93, at *54 (Jan. 18, 2006), *rev'd and remanded in part on other grounds*, 2007 U.S. App. LEXIS 27183 (9th Cir. Nov. 21, 2007) ("Further, because we have consistently held that a violation of a Commission or NASD rule or regulation is inconsistent with just and equitable principles of trade, we find that the Gebharts' sale of the unregistered MHP notes also constitutes a violation of NASD Conduct Rule 2110."); *Stephen J. Gluckman*, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395 (July 20, 1999); *see William H. Gerhauser*, Exchange Act Rel. No. 40639, 1998 SEC LEXIS 2402 (Nov. 4, 1998).

[25] *Schoemann*, 2009 SEC LEXIS 3939, at *20-21; *Gebhart*, 2006 SEC LEXIS 93, at *53.

[26] *Id.* (citing *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980)); *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004).

who is a "necessary participant" or a "substantial factor" in the unlawful transaction, including a registered representative, violates Section 5.[27]

2. The Evidence Establishes a Prima Facie Case

The facts necessary to establish a prima facie case are not in dispute. Respondents have stipulated that no registration statement was in effect with respect to the securities that are the subject of the Complaint, and admitted that they sold the securities on behalf of their clients.

There is also no dispute that interstate transportation and communications were used in connection with the transactions at issue. Many of the securities were received electronically. Certificates were typically received in the mail, and Respondents forwarded them by mail to the clearing firms, with copies to their firms' home offices. The shares were sold into the public market. Enforcement has established a prima facie case that Respondents violated Section 5 of the Securities Act of 1933 as alleged in both causes of action, and thereby violated NASD Conduct Rule 2110.

B. Respondents Have Failed to Establish the Affirmative Defense that the Transactions Qualified for the Brokers' Exemption

Exemptions from registration are affirmative defenses that must be established by the person claiming the exemption. Furthermore, "Exemptions from registration provisions are construed narrowly 'in order to further the purpose of the Act: To provide full and fair disclosure

[27] *See SEC v. Calvo*, 378 F.3d at 1215; *SEC v. Murphy*, 626 F.2d 633, 649-52 (9th Cir. 1980); *SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412, 422 (S.D.N.Y. 2007), *aff'd sub nom. SEC v. Altomare*, 300 Fed. Appx. 70 (2d Cir. 2008) (per curiam) (unpublished), *cert. denied*, 129 S. Ct. 2745 (2009); *Owen V. Kane*, Exchange Act Rel. No. 34-23827, 1986 SEC LEXIS 326, at *11 (Nov. 20, 1986).

of the character of the securities, and to prevent frauds in the sale thereof.'"[28] Evidence in support of an exemption must be explicit, exact, and not built on mere conclusory statements.[29]

1. The Brokers' Exemption, Section 4(4) of the Securities Act

Respondents have asserted as an affirmative defense that the challenged transactions were exempted from the proscription against sales of unregistered securities by Section 4(4) of the Securities Act, which exempts "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."[30] The exemption is available only if the broker conducts an inquiry adequate to determine if the securities may be sold lawfully. The SEC explained a broker's duty to investigate in a widely cited 1962 release:

> The amount of inquiry called for necessarily varies with the circumstances of particular cases. 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, either by persons who appear reluctant to disclose exactly where the securities came from, or 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.

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[28] *SEC v. Platforms Wireless Int'l Corp.*, ___ F.3d ____, 2010 U.S. App. LEXIS 15328, at *16 (9th Cir. July 27, 2010) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953)).

[29] *Schoemann*, 2009 SEC LEXIS 3939, at *23; *John G. Carley*, Exchange Act Rel. No. 57246, 2008 SEC LEXIS 222, at *24 (Jan. 31, 2008), *aff'd in relevant part, Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009).

[30] Enforcement expended considerable effort in attempting to establish that the transactions did not qualify for the exemption under Section 4(1), which exempts "transactions by any person other than an issuer, underwriter, or dealer" from Section 5's registration requirement. 15 U.S.C. § 77d(1). "Section 4(1) is intended to exempt routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions." *Schoemann*, 2009 SEC LEXIS 3939, at *24 (citations omitted). The applicability of that exemption is not addressed in this decision because Respondents did not claim that the transactions were exempt under Section 4(1). Respondents repeatedly asserted that they were relying solely on the "brokers' exemption" set forth in Section 4(4). Answer; Pre-Hearing Brief of Respondents at 8; Tr. 165, 890-891; Respondents' Post-Hearing Brief at 20. Respondents assert that the applicability of the Section 4(1) exemption is "unanswerable on the evidence in the record." Post-Hearing Brief at 20. Thus, they do not assert that they have satisfied the evidentiary standards applicable to establishing the Section 4(1) affirmative defense.

> The problem becomes particularly acute where substantial amounts of a previously little known security appear in the trading markets within a fairly short period of time and without the benefit of registration under the Securities Act of 1933. In such situations, it must be assumed that these securities emanate from the issuer or from persons controlling the issuer, unless some other source is known and the fact that the certificates may be registered in the names of various individuals could merely indicate that those responsible for the distribution are attempting to cover their tracks.[31]

"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 only a normal 'brokers' transaction' and not part of an unlawful distribution."[32] Although brokers are not required to be experts on the details of the Securities Act, "familiarity with the rudiments is essential."[33]

A registered representative may not delegate his responsibility to others and thereby relieve himself of responsibility for compliance with the registration requirements of Section 5 of the Securities Act.[34] The SEC and the courts have repeatedly rejected the defense by representatives that they relied on transfer agents, counsel for the issuer, clearing firms, or

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[31] Distribution by Broker-Dealers of Unregistered Securities, Exchange Act Rel. No. 6721, 1962 SEC LEXIS 74, at *4-5 (Feb. 2, 1962). The standards set forth in this 1962 release have been cited in numerous cases involving sales of unregistered securities by registered representatives. *See, e.g., Geiger v. SEC*, 363 F.3d 481, 485 (D.C. Cir. 2004); *Jacob Wonsover*, 1999 SEC LEXIS 430, at *28; *see also* FINRA Reg. Notice 09-05, at 4.

[32] *Robert G. Leigh*, Exchange Act Rel. No. 27667, 1990 SEC LEXIS 153, at *10 (Feb. 1, 1990); *see also* Sales of Unregistered Securities by Broker-Dealers, Exchange Act Rel. No. 9239, 1971 SEC LEXIS 19, at *7-8 (July 7, 1971).

[33] *Paul L. Rice*, Exchange Act Rel. No. 11667, 1975 SEC LEXIS 775, at *5 (Sept. 22, 1975); see also *Leigh*, 1990 SEC LEXIS 153, at *11; *Robert Stead*, 1971 SEC LEXIS 3977, at *98 (Dec. 21, 1971) ("Indeed, such a professional has a duty to be familiar with the registration requirements of the Securities Act as well as the circumstances under which an exemption from such requirements is available."); *Quinn & Co.*, Exchange Act Rel. No. 9062, 1971 SEC LEXIS 428, at *19 (Jan. 25, 1971), *aff'd*, 452 F.2d 943 (10th Cir. 1971); *Stone Summers & Co.*, Exchange Act Rel. No. 9839, 1972 SEC LEXIS 835, at *9 (Nov. 3, 1972) ("We have previously emphasized that broker-dealers have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available.").

[34] *Wonsover*, 1999 SEC LEXIS 430, at *15 (finding that reliance on transfer agent and respondent's firm did not relieve the individual broker of his obligation to explore whether shares are freely tradable); *Leigh*, 1990 SEC LEXIS 153, at *14 ("the transfer agent's willingness to reissue the certificates without restrictive legends did not relieve [the registered representative] of his obligation to investigate.").

assurances from issuers that a stock was "free trading." It is also inadequate for representatives to rely solely on their firms to conduct the necessary investigation.[35]

2. Respondents Have Not Met Their Burden of Establishing an Affirmative Defense Under the Brokers' Exemption

Respondents did virtually nothing to assure themselves that the transactions were lawful, choosing instead to rely on whatever measures might be taken by clearing firms, transfer agents, and their firms' compliance departments – procedures about which they knew virtually nothing. FINRA, the courts, and the SEC have all emphasized the need for careful scrutiny of sales of unregistered securities. The fact that the transactions did not qualify for the Rule 144 safe harbor, as Padilla testified, should have prompted even greater scrutiny. "[P]ersons who offer or sell restricted securities without complying with Rule 144 are hereby put on notice by the Commission that in view of the broad remedial purposes of the Act and of public policy which strongly supports registration, they will have a substantial burden of proof in establishing that an exemption from registration is available for such offers or sales and that such persons and the brokers and other persons who participate in the transactions do so at their risk."[36]

Respondents failed to establish that they satisfied the requirements of a Section 4(4) exemption, and therefore violated Section 5 of the Securities Act and NASD Conduct Rule 2110.

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[35] *Id.* at *12-14; *Wonsover*, 1999 SEC LEXIS 430, at *29 (stating that the SEC has rejected the "truncated view" that a representative could function as a "mere order taker" and rely on his firm and the transfer agent to conduct the appropriate inquiry); *Rice*, 1975 SEC LEXIS 775, at *5; Distribution by Broker-Dealers of Unregistered Securities, Exchange Act Rel. No. 6721, 1962 SEC LEXIS 74, at *3 (Feb. 2, 1962) ("[A] dealer who offers to sell, or is asked to sell a substantial amount of securities must take whatever steps are necessary to be sure that this is a transaction not involving an issuer, person in a control relationship with an issuer or an underwriter. For this purpose, it is not sufficient for him merely to accept 'self-serving statements of his sellers and their counsel without reasonably exploring the possibility of contrary facts.'"); Sales of Unregistered Securities by Broker-Dealers, Exchange Act Rel. No. 9239, 1971 SEC LEXIS 19, at *8 (July 7, 1971) ("Any determination that such an exemption exists should only be made after the broker-dealer has reviewed the facts surrounding the acquisition of the shares and competent outside counsel having no proprietary interest in the offering has furnished a supporting opinion describing the relevant facts in sufficient detail to provide an explicit basis for the legal conclusions stated.").

[36] *Schoemann*, 2009 SEC LEXIS 3939, at *25, quoting Securities Act Rel. No. 5223 (Jan. 11, 1972); s*ee SEC v. Cavanagh*, 445 F.3d 105, 113 (2d Cir. 2006) (the adopting release "establishes a presumption that those not covered by [Rule 144] are likewise outside Section 4(1)").

a) Respondents Ignored Warning Signs that They Were Participating in Unlawful Distributions

Even without conducting a reasonable investigation, Respondents knew a number of facts that should have heightened their concern about the lawfulness of these transactions. They involved substantial blocks of little-known, thinly traded Pink Sheet securities that were being resold soon after being deposited with Respondents' firms. "The immediacy of the resales evidences […] lack of intention to hold the securities for investment purposes, and indicates that, instead, the purchases and resales were part of a distribution." [37] The issuers were little-known companies, with little or no sales.

The pattern of deposits of large blocks of unregistered securities by consultants, who often then transferred shares to other consultants, should have caused Respondents to determine whether the consulting arrangements were an attempt to disguise illegal distributions. While transfers of unregistered securities to consultants as compensation for services may be lawful under certain circumstances, there have been many cases in which transactions involving distributions by or to consultants have been found to be unlawful.[38] Furthermore, even where shares are initially issued for bona fide consulting services, subsequent resales for the purpose of raising capital for the issuer are unlawful.[39] Many of their clients were previously unknown to

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[37] *Gary E. Bryant*, Exchange Act Rel. No. 32357, 1993 SEC LEXIS 1347, at *10 (May 24, 1993); *see also SEC v. Olins*, 2010 U.S. Dist. LEXIS 22875, at *5 (Mar. 12, 2010) ("Ordinarily, when inquiring as to whether the subject securities were acquired with 'a view to' distribution, courts look to whether the defendant held the shares for a period of more than two years."); *Ackerberg v. Johnson*, 892 F.2d 1328, 1336 (8th Cir. 1989) (two years as a rule of thumb).

[38] *SEC v. Platforms Wireless Int'l Corp.*, ___ F.3d ____, 2010 U.S. App. LEXIS 15328 (9th Cir. 2010); *Schoemann*, 2009 SEC LEXIS 3939; *Newbridge Securities Corp.*, 2009 SEC LEXIS 2058 (A.L.J. June 9, 2009); *SEC v. Sierra Brokerage Services Inc.*, 608 F. Supp. 2d 923 (S.D. Ohio 2009); *SEC v. Phan*, 500 F.3d 895 (9th Cir. 2007); *SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412 (S.D.N.Y. 2007), *aff'd sub nom. SEC v. Altomare*, 300 Fed. Appx. 70 (2d Cir. 2008) (per curiam) (unpublished), *cert. denied*, 129 S. Ct. 2745 (2009); *see also* cases cited in Proposed Rule: Use of Form S-8 and Form 8-K by Shell Companies, 2004 SEC LEXIS 827, at *12, fn.23 (Apr. 15, 2004), and Registration of Securities on Form S-8, 64 Fed. Reg. 11,103 (Mar. 8, 1999).

[39] *SEC v. Phan*, 500 F.3d at 902, 906.

Respondents, and they typically made no effort even to determine the general nature of their clients' alleged consulting businesses.

Even what little information Respondents had concerning the alleged consultants should have caused some concern. S.M. represented that his business was investing, but received VMT shares for consulting. P.B., a golf caddie, also received VMT shares for consulting. J.W. was employed by a car dealership, and R.P. was the owner of a seafood company, yet they received shares of Aladdin as compensation for consulting. The circumstances of these transactions were especially dubious, and Respondents should have inquired. Padilla also should have been concerned about the lawfulness of S.D.'s transactions. Padilla knew that S.D. was in the business of "investor awareness" and helping companies raise capital, and thus could well have been a substantial factor in the distribution of the unregistered VMT shares.[40]

b) Respondents' Complete Failure to Investigate Deposits by Electronic Transfers Is Inadequate to Satisfy Section 4(4)

For the bulk of the transactions – those that involved electronic transfers – Respondents did nothing at all. Once they told their firms that securities would be received by electronic transfer, they merely proceeded to engage in transfers of those securities to apparently unrelated customers, and sales into the market. The complete absence of an investigation is obviously not a "searching inquiry."

For the shares received by electronic transfer, Respondents have failed to establish the applicability of the exemption under Section 4(4), and therefore violated Section 5 and Rule 2110.

[40] *See SEC v. Sierra Brokerage Services Inc.*, 608 F. Supp. 2d at 951, n.28; *Robert Testa*, Securities Act Rel. No. 7018, 1993 SEC LEXIS 2473 (Sept. 29, 1993) (consent) (finding that defendant was a "necessary participant" in an unregistered distribution due to his participation in drafting and disseminating a solicitation letter).

c) Respondents' Minimal Inquiries for Transactions Involving Physical Certificates Were Inadequate to Satisfy Section 4(4)

The procedures to which Respondents testified with respect to the deposit of certificates were also inadequate. Respondents' principal argument is that they reasonably relied on their firms' compliance departments, and on transfer agents and clearing firms. As discussed above, reliance on others has been repeatedly rejected as insufficient to satisfy the requirements of Section 4(4).

To the very limited extent that Respondents made their own inquiries, they were clearly inadequate. Respondents knew virtually none of the facts necessary to determine whether they were participating in an underwriting. For example, they did not know how or why the customers who initially deposited the certificates had received their shares, whether there was a relationship between their customers and the issuers or their control persons, whether some of the proceeds of the sales were paid to the issuers, whether any services were rendered by the transferees of securities, or the percentage of either the total number of shares or public float accounted for by the securities.

Respondents' practice, as required by their firms, of sometimes obtaining corporate resolutions was also inadequate. As SEC decisions and releases and court decisions have made clear, obtaining corporate resolutions for some transactions are of little or no value in determining whether the securities could be freely traded. Issuers are not a reliable source of information concerning whether they are engaging in an unlawful distribution of unregistered securities.[41] To the extent that Respondents obtained such resolutions, they certainly do not

[41] *Rice*, 1975 SEC LEXIS 775, at *5; Distribution by Broker-Dealers of Unregistered Securities, Exchange Act Rel. No. 6721, 1962 SEC LEXIS 74, at *3 (Feb. 2, 1962); *see also Kane*, 1986 SEC LEXIS 326, at *9-10 (unreasonable to rely on seller's representation that sellers were not officers, directors, controlling persons, or insiders); *Dist. Bus. Conduct Comm. v. Orion Securities, Inc.*, 1993 NASD Discip. LEXIS 276, at *56-57 (unreasonable to rely on letter from issuer's counsel).

satisfy the requirement that they conduct a searching inquiry. Furthermore, corporate resolutions were obtained only for some of the certificates.

While Respondents alleged that their firms often retained outside counsel to review transactions, there is no evidence that outside counsel reviewed the transactions that are the subject of the Complaint. Even if there were evidence that these particular transactions were reviewed by outside counsel, Respondents have not shown what facts were made known to counsel, who counsel were, or what opinions they provided. Respondents cannot claim reliance on legal advice they never saw, and there is no evidence that such reliance would have been reasonable if Respondents had received it.

Respondents have failed to satisfy their burden of proof that they performed the inquiry necessary to satisfy the requirements of the affirmative defense under Section 4(4), the brokers' exemption.

VII. Sanctions

For the reasons set forth below, the Hearing Panel imposes a six-month suspension and a $10,000 fine for each Respondent, plus disgorgement of all commissions earned for the transactions that are the subject of the Complaint.

A. Sanction Guidelines for the Sale of Unregistered Securities

For the sale of unregistered securities in violation of NASD Conduct Rule 2110 and Section 5 of the Securities Act, the FINRA Sanction Guidelines ("Guidelines") recommend a fine of $2,500 to $50,000. The recommended fine may be increased by adding the amount of a respondent's financial benefit. In egregious cases, the Guidelines recommend consideration of a suspension in any or all capacities for up to two years or a bar. The Guidelines set forth three specific considerations for the sale of unregistered securities, two of which are relevant here:

whether respondent attempted to comply with an exemption from registration, and the share volume and dollar amount of transactions involved. Guidelines at 26.

The Hearing Panel finds that Respondents' violations were egregious. The complete absence of any genuine attempt to comply with an exemption from registration is an aggravating factor. Respondents were focused on pushing through thousands of transactions each year, paying no attention to what was required to establish the lawfulness of the transactions except to the extent their compliance departments might have required it.

The volume of transactions involved is also an aggravating factor. Respondents sold well over a billion shares of the six securities involved in this case. The dollar value of the sales of unregistered securities was more than $2.9 million, an amount paid by public customers without the protections that are the purpose of registration.

Other considerations also support a finding that Respondents' violations were egregious. Respondents' misconduct was not an isolated event, but a pattern of unlawful business transactions. They engaged in numerous acts of misconduct, involving six securities for Padilla and five for Ritchie, and multiple transactions for each security. In fact, Respondents considered these transactions so routine that they could not recall them among the thousands of similar transactions they executed. Principal Consideration #8. Respondents' violations injured the investing public by depriving them of the protections afforded by registration. Principal Consideration #11. As discussed below, Respondents' misconduct resulted in a monetary gain for both. Principal Consideration #17.

Respondents argue that their reliance on counsel was a mitigating factor, because their firms allegedly obtained legal advice concerning some of their sales of unregistered securities.

There is no evidence to support a finding that Respondents "demonstrated reasonable reliance on competent legal … advice," as required under Principal Consideration #7 of the Guidelines.

Respondents argue that their current use of more systematic and detailed investigations when selling unregistered securities is a mitigating factor. The Hearing Panel does not consider their current practices to be a mitigating factor. The Guidelines recommend consideration of "[w]hether an individual … respondent voluntarily employed subsequent corrective measures, prior to detection or intervention by the firm (in the case of an individual) or by a regulator, to revise general and/or specific procedures to avoid recurrence of misconduct." Principal Consideration #3. The current procedures were instituted by Respondents' firm in response to FINRA investigations of Respondents' conduct and other issues, and not by Respondents, and not prior to detection and intervention by a regulator. Tr. 362, 499-500, 502. Respondents did not take the kind of remedial action contemplated by Principal Consideration #3. Their current practices are not a mitigating factor.

Respondents' violations were egregious, and a substantial suspension is appropriate. In addition, a fine of $10,000 is appropriately remedial, especially when combined with disgorgement, as discussed below. For the foregoing reasons, the Hearing Panel finds that six-month suspensions and $10,000 fines are appropriate for both Respondents.

B. Respondents Are Ordered to Disgorge the Commissions They Received for the Unlawful Sales

Disgorgement of ill-gotten gains may be appropriate where a respondent obtained a financial benefit from his or her misconduct. The purpose of disgorgement is to deprive a person

of 'ill-gotten gains' and prevent unjust enrichment.[42] Adjudicators may also add prejudgment interest to the fine to take the profit out of the crime.[43]

For the VMT transactions that were the subject of the First Cause of Action, against Padilla only, the total commissions were $53,312. For the transactions charged in the Second Cause of Action, total commissions were $72,280. For transactions at Cambria, Respondents agreed that Padilla would receive 96% of the commissions, and Ritchie would receive 4%. Tr. 810; Answer ¶ 10; CX-143. For the transactions that are the subject of the second cause of action, Padilla received $69,389, and Ritchie received $2,891. Padilla is ordered to disgorge $122,701, and Ritchie is ordered to disgorge $2,891, as additional fines, plus interest thereon at the rate of interest established under Section 6621(a)(2) of the Internal Revenue Code from September 1, 2005, until paid.[44]

VIII. Conclusion

Respondents Joseph A. Padilla and Andrea M. Ritchie are suspended from associating with any member firm in any capacity for six months for violating NASD Conduct Rule 2110 by selling unregistered securities in violation of Section 5 of the Securities Act of 1933. In addition, Padilla is ordered to pay a fine of $132,701, and Ritchie is ordered to pay a fine of $12,891, which includes disgorgement and an additional fine for each Respondent.

If this decision becomes FINRA's final disciplinary action, the suspensions shall begin at the opening of business on December 6, 2010, and end on June 5, 2011. The

[42] General Principles Applicable to All Sanction Determinations #6; *see also Zacharias v. SEC*, 569 F.3d at 471-72; *Dep't of Mkt. Regulation v. Ko Sec., Inc.*, No. CMS000I42, 2004 NASD Discip. LEXIS 21, at *11 (N.A.C. Dec. 20, 2004); *Dep't of Enforcement v. Levitov*, No. CAF970011, 2000 NASD Discip. LEXIS 12, at *29-30 (N.A.C. June 28, 2000).

[43] *See, e.g., SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1476-77 (2d Cir. 1996); *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 612 (S.D.N.Y. 1993).

[44] 26 U.S.C. § 6621(a)(2).

Respondents are jointly and severally ordered to pay costs in the amount of $7,371.80, which includes a $750 administrative fee and the cost of the hearing transcript. The fines and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter.[45]

HEARING PANEL

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By: Lawrence B. Bernard
Hearing Officer

Copies to: Joseph A. Padilla (*via overnight courier and first-class mail*)
Andrea M. Ritchie (*via overnight courier and first-class mail*)
Irving M. Einhorn, Esq. (*via e-mail and first-class mail*)
Helen Barnhill, Esq. (*via e-mail and first-class mail*)
Mark J. Fernandez, Esq. (*via e-mail and first-class mail*)
Mark P. Dauer, Esq. (*via e-mail*)
David R. Sonnenberg, Esq. (*via e-mail*)

[45] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.