

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

JEFFREY M. ESPOSITO, SR.
(CRD No. 2683912),

Respondent.

Disciplinary Proceeding
No. EAF0400220004

Hearing Officer—Andrew H. Perkins

DEFAULT DECISION

March 13, 2006

Respondent made material misrepresentations and omissions of fact in connection with the offer, sale, or purchase of securities issued by L.H. Ross & Company, Inc., in violation of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110; and failed to appear for his on-the-record interview, in violation of NASD Procedural Rule 8210 and NASD Conduct Rule 2110. Respondent is barred for each violation. In addition, Respondent is ordered to pay \$63,000 in restitution, plus interest.

Appearances

Roger D. Hogoboom, Deputy Chief Litigation Counsel, Denver, CO (Rory C. Flynn, Chief Litigation Counsel, Washington, D.C., Of Counsel) for the Department of Enforcement.

No appearance for Respondent Jeffrey M. Esposito, Sr..

DECISION

I. Introduction

The Department of Enforcement (“Enforcement”) filed a Complaint against the Respondent Jeffrey M. Esposito, Sr. (“Esposito” or the “Respondent”) on November 8, 2005. The Complaint charged that Esposito (1) made material misrepresentations,

including baseless price predictions of future performance, and omitted material information in connection with the offer and sale of securities, in violation of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110; and (2) failed to appear for an on-the-record interview, as requested by NASD staff pursuant to NASD Procedural Rule 8210, in violation of NASD Conduct Rule 2110 and NASD Procedural Rule 8210.

Esposito did not answer or otherwise respond to the Complaint. Consequently, on February 1, 2006, Enforcement filed a Motion for Entry of Default Decision ("Motion"). Enforcement's Motion is supported by the Declaration of Roger D. Hogoboom ("Decl.") and five exhibits. Esposito did not respond to the Motion. Thus, pursuant to NASD Procedural Rules 9215 and 9269, the Hearing Officer grants Enforcement's Motion.

II. Respondent's Default

On November 4, 2005, Enforcement served the Complaint and Notice of Complaint on Esposito by certified and first-class mail, sent to his current residential address, as reflected in the Central Registration Depository (the CRD address). In addition, Enforcement served Esposito at an alternate address Esposito gave to an NASD examiner on March 29, 2005, in connection with another examination.¹ The signed return receipt for the certified mailing sent to Esposito's alternate address was returned to Enforcement showing that it had been delivered on November 7, 2005.² Esposito did not file an Answer.

¹ Decl. ¶ 6.

² Ex. 3.

On December 9, 2005, Enforcement served the Complaint and Second Notice of Complaint on Esposito in an identical manner. Again, Enforcement received a signed return receipt for the certified mailing sent to Esposito's alternate address. The receipt reflected that the mailing was delivered on December 15, 2005.³ Esposito did not file an Answer to the Complaint.

Enforcement complied with NASD Procedural Rule 9134(b)(1) by mailing the Complaint and Notices of Complaint to the Respondent's CRD address and an alternate address NASD had obtained from the Respondent, thereby providing constructive notice of this proceeding. In addition, the signed receipts for service of the Complaint and Notices of Complaint at the alternate address show that the Respondent received actual notice of this proceeding. Accordingly, by failing to file an Answer or otherwise respond to the Complaint, Esposito defaulted. The Hearing Officer therefore deems the allegations in the Complaint admitted pursuant to Rules 9215(f) and 9269(a)(2).

III. Jurisdiction

According to Esposito's CRD record, he was associated with L.H. Ross & Company, Inc. ("LH Ross"), a former NASD member firm, between February and October 2003 during which time he was registered as a General Securities Principal and a General Securities Representative.⁴ The Respondent was last registered in the same capacities through member firm Barron Moore, Inc. from April 8, 2004, until November 29, 2004.⁵

³ Ex. 5.

⁴ Ex. 1 at 10.

⁵ *Id.* at 6.

Article V, Section 4 of the NASD By-Laws allows NASD to retain jurisdiction over a formerly registered person for two years following his or her date of termination. Moreover, Article V, Section 4 of the NASD By-Laws specifically grants NASD the power to request information from formerly registered persons during this period of retained jurisdiction.

The Complaint alleges misconduct that occurred while he was associated with LH Ross. In addition, NASD staff mailed the information requests that are the subject of the Second Cause of Complaint and filed the Complaint within two years after Esposito's last registration terminated. Thus, NASD has jurisdiction over Esposito and this proceeding.

IV. Findings of Fact

A. L.H. Ross's Private Placement Offering

In January 2003, LH Ross initiated a private offering consisting of 5,000 units of LH Ross, priced at \$1,400 per unit. According to the 55-page private placement memorandum ("2003 PPM") dated January 6, 2003, a unit contained 100 shares of convertible preferred stock, valued at \$14 per share, with a dividend of 6% per annum, payable quarterly. The preferred stock was convertible to two shares of common stock after the closing of a public offering of LH Ross securities, which LH Ross intended "to proceed with at some point in the near future as may be required by the underwriters of the IPO or the NASD." The total amount to be raised in the private offering was \$7 million.⁶

According to the 2003 PPM, the offering price was arbitrarily determined by LH Ross and did not "bear a relationship to [the firm's] financial position, book value or any

⁶ Compl. ¶ 3.

other generally accepted criteria of value.” The 2003 PPM indicated that the investment involved a “high degree of risk” and should only be considered by investors who can “afford to sustain a loss of their entire investment ... [and] have no need for liquidity in this investment,” as there is “no market for the [u]nits.” The units were not registered with the SEC or in any state and could not be sold or transferred until registered or an exemption from registration applied. LH Ross never initiated any steps to proceed with a public offering.⁷

The 2003 PPM outlined several “risk factors.” These included LH Ross’s net loss of more than \$2.2 million in fiscal year 2001 and more than \$1.1 million in fiscal year 2002, as well as the possible need for additional financing to fund operational needs and meet capital requirements, in addition to proceeds from the offering. The 2003 PPM also disclosed that as of January 2003, there were approximately nine arbitration claims pending against the firm, and that it had been involved in actions brought by NASD and a number of state regulatory authorities. In addition, the 2003 PPM disclosed that LH Ross had not paid dividends since the end of 2001 and that the promised dividend in the 2003 offering may be deferred in the sole and absolute discretion of LH Ross’s Board of Directors.⁸

B. Esposito’s Misrepresentations and Omissions of Material Fact

The first cause of the Complaint charges that Esposito made material misrepresentations and omitted material facts in connection with the sale of interests in the 2003 LH Ross private placement offering to three customers, SE, GP, and NA.

⁷ *Id.* ¶ 4.

⁸ *Id.* ¶ 5.

(1) Customer SE

In 2003, SE had an account at LH Ross, and Esposito was his registered representative. The Complaint charges that, on or before August 26, 2003, Esposito told SE that Esposito had “inside information” that LH Ross was going to merge with a publicly traded broker-dealer in “three months or so.” Thus, Esposito told SE that he would enjoy a return of not less than 20% when the company went public if he purchased units in the private placement. SE relied on Esposito’s representations and invested \$14,000. SE received the stock certificate evidencing his investment on February 3, 2004. However, he never received a copy of the 2003 PPM.⁹

Esposito’s representation that LH Ross was about to merge with a publicly traded broker-dealer was false. In addition, Esposito failed to inform SE of the substantial risks associated with an investment in the 2003 LH Ross private placement.¹⁰

(2) Customer GP

In 2003, GP has an account with LH Ross. At the time, GP was 81 years old and retired. In early May 2003, Esposito recommended that GP invest in the LH Ross private placement. Esposito told GP that LH Ross would go public within one year and that in the meantime GP could expect a dividend on his investment of 6.5%. In addition, Esposito told GP that he could expect to double his money when LH Ross went public. GP relied on Esposito’s representations and, on May 13, 2003, he invested \$49,000 in the 2003 LH Ross private placement. Esposito did not provide GP with a copy of the 2003 PPM until June 29, 2003.

⁹ *Id.* ¶ 10.

¹⁰ *Id.* ¶ 11.

In connection with the sale of the 2003 LH Ross private placement units to GP, Esposito failed to inform GP of any of the risk factors associated with the investment. Nor did Esposito inform GP that LH Ross had suffered operating losses in 2001 and 2002 and that it had ceased making any dividend payments in 2001.

(3) Customer NA

In 2003, NA had an account with LH Ross. In May or June 2003, Esposito recommended that NA invest in the 2003 LH Ross private placement. Esposito advised NA that LH Ross was due to go public in two or three months at which time he would double his investment. Esposito predicted that the public offering would be priced at \$28 per share and would quickly rise to \$50 or \$51 per share in the aftermarket. In addition, Esposito told NA that he would receive a 6% dividend on his private placement investment.¹¹

NA relied on Esposito's representations and, on June 10, 2003, invested \$14,000 in the private placement.

Esposito failed to inform NA of any of the risk factors associated with his investment in the 2003 LH Ross private placement. Esposito never provided NA with a copy of the 2003 PPM. Moreover, Esposito failed to inform NA that LH Ross had stopped making dividend payments in 2001 and that the firm had taken no steps to go public.¹²

C. Failure to Appear for On-The-Record Testimony

The second cause of the Complaint charges that Esposito failed to appear and give sworn testimony in February and April 2005.

¹¹ *Id.* ¶ 16.

¹² *Id.* ¶ 17.

NASD staff issued two written requests pursuant to NASD Procedural Rule 8210 that directed Esposito to appear for an on-the-record interview on February 24, 2005. Both requests were mailed to Esposito's CRD address by certified and first-class mail. Esposito did not respond in any manner.

On March 29, 2003, NASD staff learned of a possible better address for Esposito. Accordingly, NASD staff sent another written request pursuant to Procedural Rule 8210, which directed that he appear for his on-the-record interview on April 14, 2005. This request was mailed to both his CRD address and the newly obtained address by certified and first-class mail.¹³ Again, Esposito did not respond in any manner.¹⁴

V. Conclusions of Law

A. Material Misrepresentations and Omissions

Securities Act Section 17(a), Exchange Act Section 10(b), and Rule 10b-5 prohibit fraudulent and deceptive acts and practices in connection with the sale of a security. In proving a violation of Section 17(a)(2), Enforcement must show that Esposito misrepresented or omitted material facts in connection with the offer or sale of a security; scienter is not required.¹⁵ In order to establish a violation of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, Enforcement must show that Esposito made material misrepresentations or omissions in connection with the purchase or sale of a security, and that he acted with scienter.¹⁶ Scienter is "a mental state embracing intent to

¹³ NASD received a signed return receipt for the certified mailing sent to the new address. The receipt shows that the mailing was delivered on April 1, 2005. Compl. ¶ 29.

¹⁴ *Id.* ¶¶ 28, 30.

¹⁵ Proof of scienter also is required under Section 17(a)(1), but not under Sections 17(a)(2) or 17(a)(3). *Aaron v. SEC*, 446 U.S. 680, 697-700 (1980).

¹⁶ *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996).

deceive, manipulate, or defraud.”¹⁷ Reckless conduct can satisfy the scienter requirement under Exchange Act Rule 10b-5.¹⁸ Further, scienter may be shown by circumstantial evidence.¹⁹

Information is material if there is a “substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest].”²⁰ To be material “[t]he information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as significantly altering the ‘total mix’ of information available.”²¹ Material facts include those investors would want to consider when making a decision whether to buy, sell, or hold a stock.²²

NASD Conduct Rule 2120, NASD’s anti-fraud provision, parallels Exchange Act Rule 10b-5.²³ Both are designed to “ensure that sales representatives fulfill their obligation to their customers to be accurate when making statements about securities.”²⁴ A violation of NASD Conduct Rule 2120 is also a violation of Conduct Rule 2110.²⁵

Here, the evidence shows, and Esposito admits by default, that he made oral misrepresentations to customers SE, GP, and NA to persuade them to purchase units of

¹⁷ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

¹⁸ *SEC v. Burns*, 816 F.2d 471 (9th Cir. 1987).

¹⁹ *U.S. v. Mylett*, 97 F.3d 663 (2nd Cir. 1996).

²⁰ *SEC v. Mayhew*, 121 F.3d 44, 51 (2nd Cir. 1997) (citations omitted).

²¹ *Id.*, citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

²² *Id.*

²³ *Department of Enforcement v. Justin E. Apgar*, 2004 NASD Discip. LEXIS 9 at *11 (N.A.C. May 18, 2004).

²⁴ *District Bus. Conduct Comm. v. Euripides*, 1997 NASD Disip. LEXIS 45, at *16-17 (N.B.C.C. July 28, 1997).

²⁵ *Id.* at *19.

the LH Ross private placement.²⁶ Esposito touted the private offering as a great opportunity to double their money once LH Ross went public, which he claimed would happen soon. In reality, LH Ross had taken no steps to have its stock traded publicly, such as filing a registration statement with the SEC. Furthermore, there was no reasonable basis for Esposito's predictions that the price would rise, particularly when LH Ross had arbitrarily set the price of the preferred stock and was contending with financial problems and regulatory issues.

Esposito also told his customers that they would receive dividends exceeding current interest rates. In truth, Esposito knew or should have known that LH Ross had not paid dividends since 2001 and was struggling financially, having suffered net operating losses in 2001 and 2002.

The Hearing Officer finds that Esposito's misrepresentations and omissions were material. Baseless price predictions are inherently fraudulent and constitute material misrepresentations, even if stated as an opinion rather than a guarantee.²⁷ Moreover, there is a substantial likelihood that a reasonable investor would have found the information Esposito omitted—the true status of the predicted public offering, the method for pricing the preferred stock, and the financial condition of the firm, including the lack of dividend payments for many months preceding their purchases—important, if not crucial, to their investment decisions. This is particularly true in a private self-offering, where there are few if any alternate sources of information about the firm available to investors.

²⁶ Statements made to persuade customers to purchase securities are made "in connection with" the purchase or sale of a security. *SEC v. Jakubowski*, 150 F.3d 675, 679 (7th Cir. 1998), *cert. denied*, 525 U.S. 1103 (1999).

²⁷ *Dane S. Faber*, Exchange Act Release No. 49,216, 2004 SEC LEXIS 277, at *16 (Feb. 10, 2004).

In addition, the Hearing Officer finds that Esposito acted with scienter. As an LH Ross registered representative, Esposito knew, or had easy access to information that demonstrated, that his statements were false. For example, the 2003 PPM disclosed that investing in the private offering involved considerable risk, and purchasers could easily lose their entire investments. Esposito intended to misrepresent the terms and risks of the LH Ross private placement, which is the reason he withheld providing the customers with copies of the 2003 PPM before they invested. Accordingly, the Hearing Officer concludes that Esposito violated Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110. In addition, the Hearing Officer finds that Esposito violated the antifraud provisions of Section 17(a) of the Securities Act through NASD Rule 2110.

B. Failure to Appear for On-the-Record Interviews

The Second Cause of Complaint alleges that Esposito twice failed to appear for his on-the-record interview, in violation of NASD Procedural Rule 8210 and Conduct Rule 2110. Here, although Esposito received valid constructive notice of the requests,²⁸ he failed to appear for the interviews. Esposito thereby violated Procedural Rule 8210 and Conduct Rule 2110.²⁹

²⁸ See *David I. Cassuto*, Exchange Act Release No. 48,087, 2003 SEC LEXIS 1496, at *9 (June 25, 2003).

²⁹ A violation of Procedural Rule 8210 is also a violation of Conduct Rule 2110. *Department of Enforcement v. Baxter*, No. C07990016, 2000 NASD Discip. LEXIS 3, at *25 (N.A.C. Apr. 19, 2000).

VI. Sanctions

A. Misrepresentations and Omissions of Material Facts

The NASD Sanction Guidelines for misrepresentation suggest imposing a bar for egregious misconduct that is either intentional or reckless.³⁰ This is an egregious case. Esposito purposely misled his customers by telling them that they would double their money when LH Ross completed an upcoming public offering, which they knew was not going to occur. Esposito failed to provide his customers with crucial information regarding the risk associated with investing in the LH Ross private placement. In addition, each customer lost his entire investment.³¹ On the other hand, there are no mitigating factors. Accordingly, Esposito will be barred for these violations.

In addition, the Sanction Guidelines provide that restitution should be ordered in appropriate circumstances to remediate a respondent's misconduct.³² Here, SE, GP, and NA each unjustly suffered a quantifiable loss as a result of Esposito's misconduct, none of which has been repaid. Accordingly, the Hearing Officer also will order Esposito to pay restitution to each customer.

B. Failure to Appear for On-the-Record Interviews

Procedural Rule 8210 authorizes NASD to require any person subject to its jurisdiction to provide information and testimony related to any matter under investigation. The Rule serves as a key element in NASD's oversight function and allows

³⁰ NASD Sanction Guidelines 93 (2005 ed.).

³¹ NASD expelled LH Ross from NASD membership in January 2005 because it had engaged in fraudulent sales practices in connections with its private placement offerings in 2003 and 2004. Compl. ¶ 9.

³² NASD Sanction Guidelines at 4 (General Principle 5).

NASD to carry out its regulatory functions without subpoena power.³³ For failing to respond in any manner to NASD staff requests for information issued pursuant to NASD Procedural Rule 8210, the Sanction Guidelines recommend the imposition of a bar unless mitigating circumstances exist to warrant a lesser sanction.³⁴ Here, there is no evidence of mitigating circumstances that would warrant a lesser sanction. Accordingly, the Respondent will be barred for this violation.

VII. Order

Jeffrey M. Esposito, Sr. is barred from association with any member firm in any capacity for material misrepresentations and omissions of material facts in connection with the sale or purchase of securities, in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110; and for failing to appear for his on-the-record interviews, in violation of NASD Procedural Rule 8210 and NASD Conduct Rule 2110. The bars will become effective immediately if this Default Decision becomes NASD's final disciplinary action in this proceeding.

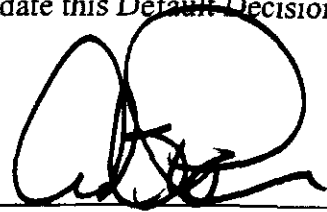
Esposito is further ordered to pay restitution in the following amounts: \$14,000 to SE; \$49,000 to GP; and \$14,000 to NA.³⁵ In addition, Esposito is ordered to pay interest on the foregoing amounts at the rate set forth in Section 6621(a) of the Internal Revenue

³³ See *Joseph G. Chiulli*, Exchange Act Release No. 42,359, 2000 SEC LEXIS 112, at *16; *Dep't of Enforcement v. Benz*, No. C01020014, 2003 NASD Discip. LEXIS 11, at *18 (OHO Mar. 4, 2003), *aff'd*, 2004 NASD Discip. LEXIS 7 (N.A.C May 11, 2004) ("Because NASD has no subpoena power, timely and full compliance with information requests is essential to NASD's self-regulatory function.").

³⁴ NASD Sanction Guidelines at 35.

³⁵ Esposito's obligation to pay restitution shall be offset by any restitution paid to the customers by LH Ross, which was ordered to pay a total of \$11,011,008 in restitution to investors who purchased shares in the 2003 and 2004 LH Ross private placements. Compl. ¶ 9. Enforcement represents that LH Ross has not made any such payments to date.

Code, 26 U.S.C. § 6621(a)(2). Interest shall accrue on the unpaid amount for each customer from the date of his investment. If this Default Decision becomes NASD's final disciplinary action in this proceeding, the order to pay restitution shall become effective on a date set by NASD, but no sooner than 30 days after the date this Default Decision becomes NASD's final disciplinary action.

A handwritten signature in black ink, appearing to read 'Andrew H. Perkins', written over a horizontal line.

Andrew H. Perkins
Hearing Officer

Copies to:

Jeffrey M. Esposito, Sr. (by overnight courier and first-class mail)
Roger D. Hogoboom, Esq. (by first-class and electronic mail)
Rory C. Flynn, Esq. (by first-class and electronic mail)