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FINANCIAL INDUSTRY REGULATORY AUTHORITY[1]
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RESPONDENT 2, Respondent.	Disciplinary Proceeding No. 20050000720-02 **HEARING PANEL DECISION** Hearing Officer – SW Date: December 11, 2007

The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent 2's supervision violated NASD Conduct Rules 3010 and 2110. Accordingly, the Complaint against Respondent 2 is dismissed.

Appearances

Elissa M. Meth, Esq., Senior Regional Attorney, and William St. Louis, Esq., Deputy Regional Chief Counsel, New York, NY, for the Department of Enforcement.

_____, Esq., New York, NY, for Respondent 2.

DECISION

I. PROCEDURAL HISTORY

A. Complaint and Answer

On December 4, 2006, the Department of Enforcement ("Enforcement") filed a four-count Complaint against two respondents, Respondent 1[2] and Respondent 2. Counts one, two, and three of the Complaint allege that during the period from October 2003 to November 2004, Respondent 1 (1) engaged in excessive trading, churning, and made

[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD.

[2] On April 25, 2007, the Hearing Officer deemed Respondent 1 in default pursuant to Rule 9241(f).

unsuitable recommendations in the account of customers CSR and SG at [Firm J], (2) prepared account applications for the customers with false information, and (3) made misrepresentations to the customers regarding their account balances. Count four of the Complaint alleges that Respondent 2, Respondent 1's supervisor, did not reasonably supervise Respondent 1 because he failed to discover or prevent Respondent 1's excessive trading, churning, unsuitable recommendations, and preparation of false account applications.

Respondent 1 defaulted by failing to answer or otherwise respond to the Complaint, and the charges against him will be addressed in a separate default decision. Accordingly, this Decision only addresses count four of the Complaint, except to the extent that the alleged misconduct by Respondent 1 is relevant to the sole charge against Respondent 2, i.e., his supervision of Respondent 1. Respondent 2 denied the allegation of inadequate supervision.

B. Hearing

The Hearing Panel, consisting of a current member of the District 10 Committee, a current member of the District 11 Committee, and a Hearing Officer, conducted a Hearing in New York, NY, on August 15-17, 2007.[3]

The Hearing Panel determined that Enforcement failed to prove by a preponderance of the evidence that during the applicable period of supervision Respondent 2 failed to exercise reasonable supervision over Respondent 1. Accordingly, Respondent 2 is found not to have violated NASD Conduct Rules 3010 and 2110, and the Complaint is dismissed as to Respondent 2.

[3] "Tr." refers to the transcript of the Hearing held August 15-17, 2007; "CX" refers to the exhibits submitted by Enforcement; "RX" refers to the exhibits submitted by Respondent 2; and "JX" refers to the exhibits submitted jointly by Enforcement and Respondent 2.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Background

1. Respondent

On September 26, 2002, Respondent 2 joined the Firm J as a general securities principal after terminating his employment with [Firm L]. (CX-1, pp. 5, 7). At the time of the Hearing, Respondent 2 maintained his registrations with Firm J. (CX-1, p. 5).

2. Respondent 1's Customers CSR and SG

In January 2003, CSR and SG, the uncle and aunt of Respondent 1, respectively, became customers of Respondent 1 while he was registered at a prior firm, Firm L. (CX-2, p. 11; CX-17, p. 1). Respondent 2 met Respondent 1 when they both worked at Firm L. (Tr. p. 692).

In 2003, CSR was 61-years old and had retired as a line supervisor at _____, where he had supervised about 200 production people. (Tr. pp. 42-43). CSR was a high school graduate who had never taken a finance class and spoke English as his second language. (Tr. pp. 40-41). CSR's wife, SG, was a 51-year old housewife, who was a machine operator until 1996. (Tr. p. 42; JX-3, p. 4). SG was also a high school graduate. (Tr. p. 42). Prior to opening the Firm L account, CSR's and SG's securities investment experience was limited to the purchase of bonds through their bank prior to CSR's retirement and to a brokerage account that the customers opened one year earlier, in January 2002, at [Firm S]. (JX-2, p. 5; JX-3; Tr. p. 48).

CSR and SG funded the Firm L account with deposits of $306,289.26 on February 25, 2003.[4] (CX-49, p. 4). Respondent 1 understood that the money constituted the couple's life savings and that they needed the funds for their retirement. (Tr. pp. 62-63). Respondent 1 assured CSR that the money would be in "good hands." (Tr. p. 64).

The February 2003 Firm L account statement listed capital appreciation as the couple's investment objective and moderate as their risk profile. (CX-49, p. 3). A month later, however, Respondent 1 updated the account information to reflect an aggressive/speculative investment objective for CSR and SG. (CX-44, pp. 1-4). CSR and SG signed the update. (Id.). Despite the aggressive/speculative investment objective, the account was invested in Class A mutual funds. (CX-49, pp. 6-10).

CSR advised Respondent 1 that he intended to withdraw about $3,000 a month from the account for living expenses. (Tr. p. 64). Consistent with these instructions, Firm L sent CSR approximately $3,000 monthly. (CX-49).

3. CSR and SG's Firm J Account

On August 29, 2003, Respondent 1 became registered with Firm J as a general securities representative. (CX-2, p. 9). At Firm J, Respondent 2 was appointed Respondent 1's general securities principal ("GSP"). (Tr. pp. 553-554). In September 2003, CSR agreed to transfer his funds from Firm L to Firm J because Respondent 1 was "family." (Tr. p. 74).

[4] CSR and SG opened six accounts at Firm L with Respondent 1 as the investment representative, but only two of the accounts were funded. (CX-17; CX-49). The four Firm L account statements included in the exhibits falsely listed the customers' income as $100,000. (CX-44). CSR does not remember seeing the $100,000 income on the updated Firm L account. (Tr. p. 123). None of the Firm L accounts is at issue in this case.

On September 2, 2003, CSR and SG signed a Firm J new account application that listed $60,000 income, $600,000 liquid assets, $1,500,000 net worth,[5] six years investment experience, and a 36% tax bracket. (CX-45; RX-26). CSR wrote the $600,000 and $1,500,000 figures on the Firm J application because Respondent 1 told him to do so. (Tr. p. 75). Respondent 1 told CSR, "it [would] give [him] more power or something." (Id.). CSR estimated that his income was $60,000, his liquid net worth was $300,000, and his net worth was $600,000 to $700,000. (Tr. pp. 53, 75-76). The Hearing Panel finds CSR's testimony credible with respect to his income and liquid assets. The Hearing Panel finds that the customers' net worth was approximately $1,000,000 by adding CSR's pension of $254,000 to his estimate of $700,000.[6] (Tr. pp. 110, 169). CSR did not have any discussion with Respondent 1 about a change in the customers' financial condition or a change in their investment strategy from Firm L to Firm J. (Tr. p. 80).

Although the Firm J account application failed to list an investment objective, the first Firm J account statement listed short-term growth as the investment objective. (CX-45, p. 1; CX-50A, p. 7). On October 2, 2003, Respondent 1 prepared, and Respondent 2 signed, a suitability supplement for CSR, which still listed $60,000 as the customers' income, but indicated that CSR received income from real estate and investments. (RX-24). CSR and SG did not sign the suitability supplement. (Id.). There was no evidence presented at the Hearing that the suitability supplement was provided to CSR and SG at the time that it was completed and signed.

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[5] The $1.5 million figure for the liquid assets and the $600,000 figure for net worth on the September 2, 2003 application had clearly been transposed because net worth includes liquid assets. (CX-45). *See also* CX-46 and CX-47.

[6] CSR admitted that his net worth estimate of $600,000 to $700,000 did not include his $254,000 pension. (Tr. pp. 53, 113, 169).

Approximately two weeks later, on October 16, 2003, CSR and SG's Firm L securities valued at $352,781.28 were transferred to Firm J. (CX-49, p. 39; CX-50A, p. 2). The next day, the mutual funds that had been transferred out of Firm L and into Firm J were sold. (CX-50A, pp. 2-3). Respondent 2 questioned Respondent 1 regarding the sale of the mutual funds. (Tr. pp. 731-732). Respondent 1 responded that (i) the mutual funds were Firm L relationship-based funds, part of an asset model that Firm L tracked, researched and rebalanced as necessary, and (ii) Firm J did not have the program in place to track, research, and rebalance the funds. (Tr. pp. 731-732). Respondent 2 also asked Respondent 1 about the fees that were charged on the sale of the mutual funds, and Respondent 1 falsely stated that the amounts shown were back-end fees rather than commissions. (Id.). The report produced by Firm J's clearing firm did not indicate what class of mutual fund was sold and did not distinguish between the commissions and fees charged for mutual fund trades.[7] (RX-44, p. 2).

Respondent 1 recommended that CSR use the proceeds from the mutual fund sales to implement a covered call option strategy to capitalize on short-term volatility in stocks. (Tr. pp. 708-709). The strategy was implemented through the purchase of Intel Corp. ("Intel") stock, and the purchase and sale of puts and calls on Intel. (Tr. pp. 844-846; CX-50A, pp. 1-17). Firm J set a minimum income requirement of $100,000 for customers to engage in option trades. (Tr. p. 534; CX-75, p. 2). Accordingly, in order to implement the option strategy, Respondent 1 had CSR and SG sign a Firm J account application update on October 20, 2003, that changed their income from $60,000 to $200,000, and listed $600,000 liquid assets, $1,500,000 net worth, 20 years investment

[7] Because the customers' mutual funds were all Class A shares, there were no back-end charges when they were sold, but there could have been back-end charges if the shares sold had been Class B shares.

experience, 20 years margin experience, and a high tax bracket. (CX-46). However, CSR never earned $200,000. (Tr. pp. 84-85, 158). As discussed previously, the Hearing Panel finds that the customers' annual income was approximately $60,000, their liquid assets were approximately $300,000, and their net worth was approximately $1,000,000.

In addition, on the same date that CSR and SG signed the update application, they signed a Firm J option agreement that listed $200,000 income, $600,000 liquid assets, $1,500,000 net worth (including $900,000 in real estate), 20 years investment experience, and 20 years option experience. (CX-47, pp. 1-3). In fact, the customers had no prior experience with options and did not understand the covered call program. (Tr. pp. 60-62).

On October 20, 2003, the proceeds of the customers' mutual funds were used to purchase 10,000 shares of Intel for $334,981. (CX-50A, p. 3). The Intel stock, and the calls and puts on the Intel stock, constituted 93% of the customers' account as of October 31, 2003. (CX-50A, p. 1).

4. Respondent 2's Conduct

Upon reviewing the October 2003 update and the option application, Respondent 2 questioned Respondent 1 about the changes in the customers' income and experience. (Tr. pp. 807-809). Respondent 1 responded that the updated statement was more accurate because it reflected the income generated by CSR's real estate transactions. (Tr. pp. 719, 807, 957-958).

Respondent 2 testified that he did not suspect that Respondent 1 had falsified the income figure to meet the $100,000 minimum income requirement for trading options because Respondent 1 increased the income figure to $200,000 rather than to $100,000. (Tr. pp. 908-909). When Respondent 2 asked about the change in investment experience

from six years to 20 years, Respondent 1 indicated that the original application was a mistake and that it did not accurately account for CSR's investment in bonds. (Tr. pp. 910-911). Relying on CSR's and SG's signatures on the updated forms, Respondent 2 accepted Respondent 1's explanations. (Tr. p. 911).

Pursuant to Firm J's active account procedures, if an account had 10 transactions or more in the last three month period and/or the turnover rate was 5 or higher, or the account value had decreased by more than 10%, the account was subject to further review by a compliance associate in the Compliance Department. (CX-72, p. 4; RX-31, p. 1).

When an account was chosen for review, the Compliance Department had the option of (i) directing the branch manager to contact the customer, (ii) sending an activity letter to the customer, which required a written response, or (iii) sending a negative response letter, which did not require a response from the customer. (CX-72, pp. 4-5). In October 2003, there were sufficient trades in the customers' account to trigger this review, but the Compliance Department decided not to take any action because many of the trades involved liquidating the mutual funds transferred from Firm L in order to reposition the account. (Tr. p. 550; RX-33, p. 1; CX-50A, pp. 2-5).

Respondent 2 also testified that he recommended to the Compliance Department that a concentration letter be sent to CSR and SG because most of the proceeds of the account had been invested in Intel. (Tr. pp. 816, 932-933). He made this recommendation even though he knew that, because the two Intel purchases were so large, the trades had been approved by senior management prior to execution. (Tr. pp. 815-817, 932-933). There was no evidence presented that Firm J's Compliance Department sent a concentration letter to CSR and SG.

In November 2003, there were 36 transactions in CSR's and SG's account, which included 11 option transactions, a purchase and sale of Intel on the same day, and a purchase and numerous sales of Antigenics, Inc., a biotech company. (RX-33, p. 2; Tr. p. 325; CX-50A, pp. 9-17). For example, on November 21, 2003, CSR's and SG's account purchased 15,000 shares of Antigenics on margin for a cost of $155,281. (CX-50A, pp. 12, 14).

Because of the November 2003 transactions, the account was chosen for additional review by the Compliance Department. (CX-19, p. 1). A compliance associate sent an email to Respondent 1 on December 5, 2003, advising him that a negative response letter would be sent to CSR and SG.[8] (CX-34, p. 7). Respondent 2 was not copied on the email. (Id.). On December 8, 2003, Firm J compliance associate sent a negative response letter to CSR.[9] (RX-23). CSR admitted receiving the letter, but he did not respond to it. (Tr. p. 87).

In December 2003, Respondent 2 and Respondent 1 entered into a partnership, and on December 22, 2003, the Compliance Department issued a memorandum assigning a joint account number for the partnership. (Tr. p. 555; RX-28). The Compliance Department approved the joint production in part to address Respondent 1's lateness and absenteeism problems, which Respondent 2 had raised shortly after Respondent 1 joined Firm J. (CX-78, p. 1). In light of the partnership, Respondent 2 was no longer permitted

[8] Typically, a compliance associate in Firm J's Compliance Department would notify the registered representative and his branch manger if an account had been chosen for review via email. (CX-72, p. 4). The registered representative would be given the opportunity to advise the compliance associate why the client should not receive a letter or call from the branch manager. (Id.).

[9] Respondent 2 does not remember when he was advised that the negative response letter had been sent. (Tr. pp. 939-940).

to supervise Respondent 1 as his GSP.[10] (Tr. pp. 555, 718). Mr. P. was assigned as the GSP for the partnership. (Tr. p. 625; RX-28).

Therefore, the applicable period during which Respondent 2 supervised Respondent 1 was October 2003 through December 22, 2003, rather than October 2003 through January 2004 as alleged in the Complaint.

5. CSR and SG's Firm J Account after December 22, 2003

From January 2004 to June 2004, all trades in the CSR and SG account were made under the partnership's joint account number. In June 2004, Respondent 1's partnership with Respondent 2 was dissolved, and the account again became the sole responsibility of Respondent 1. (CX-10, p. 1). Respondent 2, however, did not resume responsibility for supervising Respondent 1.

Although the account balance steadily declined in excess of 10% from December 2003 until the account was closed in November 2004, CSR did not call to complain about the activity in his account. (Tr. p. 97). In late 2004, CSR called Respondent 1 to determine why he had not received the $10,000 disbursement that he had requested. (Tr. p. 98; CX-7, p. 1). Initially, Respondent 1 explained that there had been a mix up, and the check would be re-sent. (Tr. pp. 98-99). When CSR still did not receive the check, he had his bank arrange to transfer the customers' Firm J account to the bank. (Id.). The bank told CSR that the balance of his Firm J account was $2,200. (Id.). CSR called Respondent 1, who told him it was a mistake, and CSR should have his bank re-send the papers. (Id.). Respondent 1 told CSR that he still had $270,000 in his account. (Tr. p.

[10] This change became effective immediately, even though the first trade in the CSR and SG account through the partnership was not executed until the end of January 2004. (Tr. pp. 413, 555; CX-56A, p. 1).

192). The next time that CSR called Firm J, CSR spoke to Respondent 2, who forwarded the call to the Compliance Department.[11] (CX-13, p. 2; Tr. pp. 555-556).

Although Respondent 1 had told CSR that his account balance remained at approximately $270,000 in late 2004, CSR ultimately discovered that only $2,200 remained in his account. (Tr. p. 98; RX-7, pp. 2-3 at ¶¶ 23, 30). CSR filed an arbitration complaint against Respondent 1 and Firm J, and Firm J settled with CSR for in excess of $200,000. (Tr. pp. 175, 195).

B. Supervisory Violation Not Proven

In the Complaint, Enforcement alleged that Respondent 1: (i) engaged in excessive trading, churning, and made unsuitable recommendations in the customers account; (ii) prepared account applications with false information; and (3) made misrepresentations to the customers regarding the value of their account. The evidence presented at the Hearing supported all of these allegations.

The information in the account documents did not accurately portray the customers' finances, investment experience or objectives; the options and margin trading in the account was unsuitable[12] and excessive;[13] and because the excessive trading was

[11] Respondent 1 left Firm J on December 1, 2004. (CX-2, p. 8). Respondent 1 was registered with [Firm B] from December 6, 2004 to August 3, 2005, and with [Firm N] from August 8, 2005 to September 6, 2006. (CX-2, pp. 5, 7). Respondent 1 is not currently associated with any FINRA member. (CX-2, p. 5).

[12] NASD Conduct Rule 2310(a) provides that, in recommending to a customer the purchase of a security, a representative must have reasonable grounds for believing that the recommendation is suitable for such customer based on the customer's other security holdings and financial situation and needs. *See District Bus. Conduct Comm. v. McNabb*, No. C01970021, 1999 WL 515761, at *13 (NAC Mar. 31, 1999).

[13] Several factors, including the turnover rate, the cost-to-equity ratio, "in and out" trading, and the number and frequency of trades in an account may provide a basis for a finding of excessive trading. *See Dep't of Enforcement v. Gliksman*, No. C02960039, 1999 NASD Discip. LEXIS 12 at *25, (NAC Mar. 31, 1999), *aff'd*, Exch. Act Rel. No. 42,255, 1999 SEC LEXIS 2685 (Dec. 20, 1999).

done by Respondent 1 to further his own financial interests, it amounted to churning.[14] Respondent 1 also misrepresented the value of the account to hide the losses.

The issue before the Hearing Panel, however, was whether Respondent 2 failed properly to supervise Respondent 1, in violation of NASD Conduct Rule 3010. NASD Conduct Rule 3010(a) requires each member to establish and maintain a system to supervise the activities of each representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with NASD Rules. To establish a violation of Rule 3010, "the burden is on [Enforcement] to show that the respondent's procedures and conduct were not reasonable. It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better."[15] A failure to supervise occurs when "red flags" are evident but ignored, go undetected, or fail to elicit reasonable concern.[16]

Contrary to the allegations of the Complaint, Respondent 2 supervised Respondent 1 with regard to this account only from October 2003, when the customers transferred in their account holdings to Firm J and Respondent 1 began trading in the account, until December 22, 2003, when Respondent 2 was assigned a joint account number with Respondent 1 and was therefore relieved of supervisory responsibility for him.

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[14] Churning occurs "when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions." *See Sandra K. Simpson*, Exch. Act Rel. No. 45,923, 2002 SEC LEXIS 1278, at *52 (May 14, 2002), quoting *Olson v. E.F. Hutton & Co.*, 957 F.2d 622, 628 (8th Cir. 1992).

[15] *District Bus. Conduct Comm. v. Lobb*, 2000 NASD Discip. LEXIS 11, at *16 (NAC Apr. 6, 2000).

[16] *Consolidated Investment Services, Inc*., Admin. Proc. File No. 3-8312, 1994 SEC LEXIS 4045, at **26-27 (Dec. 12, 1994). *Shearson Lehman Hutton, Inc*., Exch. Act Rel. No. 26,766, 43 S.E.C. Docket 1322 (April 28, 1989), 1989 WL 257097 at *4-5; *Prudential-Bache Securities, Inc*., Exch. Act Rel. No. 22,755, 34 S.E.C. Docket 1074 (Jan. 1, 1986), 1986 WL 272873, at *16-18.

Although Respondent 2 knew Respondent 1 from an earlier association at Firm L, there is no evidence that Respondent 2 had any reason to distrust or be suspicious of Respondent 1 based on that association. Instead, Enforcement argues that Respondent 2 should have been alerted to a problem based on: (1) the differences between the information listed in the customers' initial account opening documents in September 2003, and the options account opening documents dated just a month later; (2) transaction reports that Respondent 2 reviewed, which showed the excessive trading in the customers' account; and (3) Respondent 1's lateness and absenteeism problems.

With regard to the first argument, Respondent 2 did question Respondent 1 about the disparity between the customers' income as indicated in the September 2003 account opening document and as indicated in the October 2003 update and option documents. Respondent 1 told him that the October 2003 income figure was more accurate because it reflected income generated from the customers' real estate holdings. Although in fact the income listed on the October 2003 documents was inflated and false, Respondent 2 did not suspect that Respondent 1 had falsified the amount in order to justify options trading because the amount listed ($200,000) was twice as much as was required for options trading approval, and most importantly because the customers had signed the update and option documents.[17] Under these circumstances, the Hearing Panel did not find that the changed income information, investment objective, or investment experience constituted a red flag that should have alerted Respondent 2 of possible misconduct. The Hearing Panel finds that Respondent 2's testimony regarding his conversations with Respondent 1 about CSR's income, net worth, and interest in option trading was credible.

[17] Respondent 2 testified that he verified the signatures of the customers on the update and option documents. (Tr. p. 809).

With regard to the second argument, although Respondent 2 did receive reports that showed the transactions in the customers' account, under Firm J's supervisory system the volume of those transactions was sufficient to trigger a review by Firm J's Compliance Department. It was the Compliance Department that decided not to take any action in response to the October 2003 trading in the account, and to simply send a negative response letter to the customers in response to the November 2003 trading in the account. The Compliance Department had the option of directing the branch manager to contact the customers, but did not do so. In light of that, the Hearing Panel did not find Respondent 2's failure to take further action on his own unreasonable. Moreover, Respondent 2 credibly testified that after he reviewed the report for October 2003, he recommended that the Compliance Department send the customers a letter regarding the concentration of the account in a single stock, Intel, but there was no evidence that such a letter was sent. During the short period that Respondent 2 supervised Respondent 1 as a GSP, Respondent 2 acted in compliance with Firm J's procedures and alerted the Compliance Department to the trading in the account.[18]

With respect to the third argument, the Hearing Panel finds that Respondent 2 did act to address his concerns about Respondent 1's lateness and absenteeism. But those problems did not amount to a red flag that should have raised concerns about possible misconduct involving the CSR and SG account.

[18] *See, Lobb* at *23, fn 20 (finding that a supervisor's adherence to his or her firm's supervisory procedures will not necessarily shield the supervisor from liability; but it is a factor to be considered in determining whether supervision was reasonable).

Accordingly, the Hearing Panel did not find that Respondent 2 ignored evident red flags of possible misconduct, and therefore did not find that Respondent 2 violated NASD Conduct Rules 3010 and 2110.[19]

III. CONCLUSION

The Hearing Panel concludes that Enforcement has not established by a preponderance of the evidence that Respondent 2 failed to exercise reasonable supervision over Respondent 1, in violation of NASD Conduct Rules 3010 and 2110. Accordingly, the Complaint in this proceeding is dismissed as to Respondent 2.[20]

HEARING PANEL.

_____
Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
December 11, 2007

[19] The Complaint did not allege misconduct, and the Hearing Panel made no findings of misconduct by Respondent 2 while the account was traded in the joint partnership.

[20] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein. As noted above, a separate default decision will be issued as to Respondent 1.