BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of Department of Enforcement, Complainant, vs. Jack H. Stein West Palm Beach, FL, Respondent.	DECISION Complaint No. C07000003 Dated: December 3, 2001

Registered representative made unsuitable recommendations and traded excessively in customer account. Held, findings upheld, period of violation modified, and sanctions modified.

Jack H. Stein ("Stein") has appealed a March 6, 2001 NASD Regulation, Inc. ("NASD Regulation") Hearing Panel decision pursuant to NASD Procedural Rule 9311. After a review of the entire record in this matter, we hold that Stein made unsuitable recommendations and traded excessively in a customer account. We fine Stein $25,000 and suspend him in all capacities for three months.

Procedural History

The Department of Enforcement filed the complaint in this matter on January 11, 2000, after having received notice of a written complaint from one of Stein's customers. Stein originally requested a hearing before the Hearing Panel. He later waived a hearing, and the Hearing Officer did not order a hearing. The Hearing Panel therefore decided this matter based on the parties' written submissions.

On appeal, Stein requested a hearing. He participated in an appeal hearing via telephone conference call.[1]

[1] Stein moved to adduce additional evidence on appeal. Motions to adduce additional evidence are governed by NASD Procedural Rule 9346. Under Rule 9346, a party seeking to

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Background

Stein has been registered with the NASD as a general securities representative since June 1984. He was associated with the following firms on the following dates: Josephthal Lyon & Ross, Inc. ("Josephthal") from December 1991 until April 1996; Greenway Capital Corp. ("Greenway") from May through July 1996; Joseph Dillon & Company, Inc. ("Dillon") from July 1996 through March 1998;[2] and Baxter Banks & Smith from March 1998 through March 2000.

Facts

Customer EA, who was 56 years old and recently widowed, first met Stein in December 1992 through Stein's spouse. At the time, Stein was involved predominantly in selling speculative oil, gas, and mining securities as a registered representative with Josephthal. Between 1992 and 1994, Stein discussed the securities markets with EA, and he advised her of the risks involved in the speculative trading strategy in which he specialized.[3] In March 1994,

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adduce additional evidence must request leave to introduce the evidence and must demonstrate that there was good cause for his failure earlier in the proceeding to introduce the evidence and that the evidence is material. We admitted into the record the nine proposed exhibits attached to Stein's first and second motions to adduce additional evidence. We declined to accept into the record the additional documents that Stein attached to his notice of appeal.

[2] Although Stein was associated with Greenway for several months, his registration with that firm was never approved. Stein's association with Dillon commenced in July 1996, but his registration in New York State was not approved until January 1997.

[3] The only evidence in the record regarding whether Stein disclosed to EA the risks attendant to margin trading, whether Stein discussed with EA the investments that he recommended, and other aspects of the conversations between EA and Stein was as follows: (1) Stein's sworn testimony in an on-the-record interview; (2) EA's arbitration claim; and (3) an affidavit from an NASD staff examiner in which the examiner related his conversations with EA. The record did not contain a signed statement or affidavit from EA, and Stein's testimony differed greatly from the examiner's recitation of his conversations with EA. Although Stein waived a hearing, we do not find that affidavits can be treated the same as testimony. Accordingly, we treat the examiner's affidavit and other documents, such as EA's arbitration claim, as hearsay.

Hearsay evidence is admissible in NASD proceedings and, in appropriate cases, may be the sole basis for findings of fact. Harry Glicksman, et al., Exchange Act Rel. No. 42255 (Dec. 20, 1999). When admitting hearsay evidence, however, we must evaluate its probative value, its reliability, and the fairness of its use. Id; see also Robin Bruce McNabb, Exchange Act Rel. No. 43411 (Oct. 4, 2000) (citing Charles D. Tom, 50 S.E.C. 1142, 1145 (1992)) (factors to consider

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when EA was 57 years old, she transferred her account from her representative at Merrill Lynch, Pierce, Fenner & Smith, Inc. to Stein at Josephthal. At the time, EA's account was worth approximately $78,000 and included conservative investments, such as municipal bonds and preferred shares of Ford Motor Company. EA's new account form at Josephthal listed her annual income as $25,000 (from her position as a social worker at a hospital), her approximate net worth as $100,000, and her investment objective as income.

In May 1994, Stein opened a margin account for EA[4] and began purchasing speculative securities related to oil, gas, copper, and gold mining in EA's account. Although the equity in EA's account remained constant through the end of 1994, the positions in her portfolio became more speculative. By the end of 1994, Stein had invested 43 percent of her portfolio in speculative securities. In early 1995, Stein inserted hand-written changes to EA's new account form -- he added "spec[ulation]" to EA's investment objectives and listed her income as $55,000 and her net worth as $150,000.[5] In 1995, the frequency of trading in EA's account increased. By the end of 1995, Stein had invested 90 percent of EA's portfolio in speculative securities (60 percent of which were speculative oil, gas, and gold stocks). For example, during the first quarter of 1996, Stein increased EA's position in AGC America's Gold Corp ("AGC"), a

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in assessing reliability and probative value include possible bias of the declarant, the type of hearsay at issue, whether the statements are signed and sworn, whether the hearsay is contradicted by direct testimony, whether the declarant was available to testify, and whether the hearsay is corroborated). We do not find the examiner's affidavit and EA's arbitration claim to be sufficiently reliable and have not relied on them except as to points that Stein does not dispute. The examiner's affidavit was second-hand hearsay, since it discussed details of the examiner's conversations with EA. Furthermore, because EA did not testify, there was no way for Stein to explore whether EA might have been biased against Stein. EA's statements (as communicated in the examiner's affidavit) are contradicted by Stein's sworn on-the-record testimony, and there is little other reliable evidence to corroborate EA's statements. We conclude that the portions of the examiner's affidavit in which he relates what EA had said to him and the contents of EA's arbitration claim are not reliable and probative, and we have not relied on that evidence as to the issues that Stein disputes in reaching our decision in this matter.

[4] EA signed a margin account agreement when Stein opened the margin account.

[5] EA subsequently followed Stein to two other firms -- Greenway and Dillon. EA's new account forms for those firms, which EA signed, listed her investment objectives as growth and speculation, her income as $25,000, and her net worth as $100,000. EA's 1995, 1996, and 1997 state and federal income tax returns confirm that her annual income was approximately $25,000.

Stein testified in an on-the-record interview that he first updated EA's new account form when he moved from Josephthal's New York office to a Florida office of the firm in May 1994. He asserted that neither he nor Josephthal could produce the updated new account form from the Florida office.

speculative mining stock, to 60,850 shares, which constituted approximately 59 percent of her portfolio.

During the period from March 1994 through the end of the first quarter of 1996, the value of EA's account fluctuated significantly, but EA did not suffer any significant losses. Through April 1996, EA paid a total of $32,095.50 in commissions (for trades involving her initial transfer of investments valued at approximately $78,000). Stein's payout on the commissions was approximately $9,628.67. EA also paid $6,969.89 in margin interest during the two years that she maintained her account at Josephthal.

In April 1996, Stein resigned from Josephthal and joined Greenway. EA followed Stein and transferred her account to Greenway. The NASD never approved Stein's registration at Greenway, and Stein resigned from Greenway in July 1996 without ever having been registered. EA's account representative at Greenway was Barney Kowalski ("Kowalski"), the branch manager of the Greenway office with which Stein was associated. EA's new account form for Greenway listed her income as $25,000 per year and her net worth as $100,000. EA's investment objectives at Greenway were recorded as growth and speculation, as compared to her investment objective at Josephthal, which was listed as income.

On July 31, 1996, Stein left Greenway and became associated with Dillon. Once again, EA followed Stein and transferred her account to Dillon. Stein's registration with the State of New York was not approved until January 9, 1997. Thus, prior to January 9, 1997, Michael Minunno ("Minunno") was EA's account representative at Dillon. After January 9, 1997, Stein was EA's representative of record. EA's new account form for Dillon was consistent with her Greenway new account form.[6]

By the end of January 1997, 90 percent of EA's portfolio consisted of speculative gold and mining stocks, and AGC stock alone constituted 75 percent of EA's portfolio. From January through November 1997, the value of EA's account declined significantly, due mainly to a decline in the price of AGC and the failure of Bre-X Minerals LTD. ("Bre-X") stock, which Stein had purchased for EA's account in February 1997. As of the end of November 1997, the

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[6] Causes two and three of the complaint alleged that, during the period from May 1996 through January 9, 1997, Stein, although not registered with the NASD at Greenway and not registered with New York State at Dillon, functioned (without proper registration) as EA's representative, in violation of Conduct Rule 2110 and Membership and Registration Rules 1031 and 1032. The Hearing Panel dismissed these allegations, noting that the evidence upon which Enforcement relied, the examiner's affidavit, was not sufficiently reliable to sustain a finding. See supra note 4. The Hearing Panel also noted that the record contained no statement from Kowalski and conflicting statements from Minunno regarding Stein's involvement with EA's accounts. The Hearing Panel thus concluded that Enforcement failed to establish the registration violations. For the reasons stated in the Hearing Panel's decision, we concur and affirm the Hearing Panel's dismissal of causes two and three of the complaint.

net equity in EA's account had decreased to $38,345[7] and 80 percent of her portfolio was invested in speculative securities.[8] While at Dillon, EA paid a total of $1,009 in margin interest.

Discussion

Based on the record before us, we affirm the Hearing Panel's findings that Stein violated Conduct Rules 2110 and 2310 by recommending securities to EA that were unsuitable based on EA's financial situation and needs.[9] We confine our findings to the periods when Stein was registered and responsible for EA's account, March 1994 through April 1996 (while associated with Josephthal) and January through November 1997 (while associated with Dillon).[10]

"Before recommending a transaction, a registered representative must have reasonable grounds for believing, on the basis of information furnished by the customer, and after reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, that the recommended transaction is not unsuitable for the customer." Rafael Pinchas, Exchange Act Rel. No. 41816, at 10 (Sept. 1, 1999). As we stated in our decision in Daniel Richard Howard, Complaint No. C11970032 (NAC Nov. 16, 2000), the suitability rule can be violated in a number of ways. Most often, the rule is violated based on the quality of the recommended transactions when compared to the customer's financial situation and needs. See Pinchas, supra. The rule also can be violated if a representative's recommendations are

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[7] Between 1994 and 1997, EA withdrew more than $19,000 from her Josephthal, Greenway, and/or Dillon accounts.

[8] EA filed her first letter of complaint in October 1997. There is no evidence that she previously had complained about the trading in her account.

[9] Rule 2310 requires members to have reasonable grounds for believing that a recommendation is suitable for a customer based on his or her financial situation and needs. Under the NASD's Rules, persons associated with a member have the same duties and responsibilities as members. See General Provision 115(a). Rule 2110 requires the observance of "high standards of commercial honor and just and equitable principles of trade," and violations of other NASD Rules constitute a violation of Rule 2110. See Stephen J. Gluckman, Exchange Act Rel. No. 41628 (July 20, 1999).

[10] The complaint alleged that Stein made unsuitable recommendations to EA from March 1994 through April 1997. Although the Hearing Panel found that, during the period from May 1996 through the beginning of January 1997, Stein was not registered and did not act as EA's account representative, it nonetheless found that he made unsuitable recommendations to EA during the entire period alleged in the complaint. We affirm the Hearing Panel's finding that Stein did not act as EA's account representative from May 1996 through the beginning of January 1997. We therefore confine our suitability findings to the period from March 1994 through April 1996 and January through November 1997, rather than March 1994 through April 1997 as alleged in the complaint.

quantitatively unsuitable. As the Securities and Exchange Commission ("SEC") has recognized, "excessive trading represents an unsuitable frequency of trading and violates NASD suitability standards." Paul C. Kettler, 51 S.E.C. 30, 32 (1992); see also Harry Gliksman, Exchange Act Rel. No. 42255, at 4 (Dec. 20, 1999); Michael H. Hume, Exchange Act Rel. No. 35608, at 4 n.5 (April 17, 1995).[11] In either case, a representative may make only such recommendations -- or effect such transactions in cases where the representative controls the account -- as would be consistent with the customer's financial situation and needs. See Rafael Pinchas, supra, at 10. Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. See Pinchas, supra, at 11 (customer's desire to "double her money" does not relieve registered representative of duty to recommend only suitable investments); John M. Reynolds, 50 S.E.C. 805, 809 (1992) (regardless of whether the customers wanted to engage in aggressive and speculative trading, the representative was obligated to abstain from making recommendations that were inconsistent with their financial situation).

In this case, we find that Stein's recommendations to EA were not suitable because of the speculative nature of the securities that he recommended, the high concentration of speculative securities that he placed in EA's portfolio, the recommended use in these circumstances of margin trading, and the excessive number of trades in EA's account. Given EA's financial situation and needs, we find that the investment strategy that Stein recommended to EA was both qualitatively and quantitatively unsuitable.

The speculative and risky nature of the stocks that Stein recommended and the high concentration of those stocks in EA's account made Stein's recommendations unsuitable. When EA first transferred her account to Stein in March 1994, EA's account held conservative investments. At the time that EA opened an account with Stein, she was 57 years old and a widow. She earned a modest income of $25,000 per year and her net worth was $100,000.[12]

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[11] The NASD Board of Governors' policy statement with respect to fair dealing with customers, which appears in the NASD Manual following the suitability rule, provides in pertinent part as follows: "Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are . . . [e]xcessive activity in a customer's account . . . ." IM-2310-2.

[12] Stein testified that EA had misrepresented her net worth on her new account form because she wanted to hide assets from the Internal Revenue Service. He contended that she had other brokerage accounts and other assets that she had not disclosed on the form, and that she orally had advised him of these assets. The record does not support Stein's contention in this regard. The only reliable evidence of EA's financial situation during the periods of violation (March 1994 through April 1996 and January through November 1997) is EA's new account forms. Other evidence that Stein entered into the record regarding EA's financial situation involved periods either before or after the period of violation. Without additional substantiation, we do not find prior or subsequent financial information to be indicative of EA's financial status during the relevant period. See Larry Ira Klein, 52 S.E.C. 1030 (1996) (prior securities

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Stein's recommendations led EA to place significant portions of her asset value in speculative oil, gas, and mining securities, which were inconsistent with the relatively safe investments that she had held in the account prior to transferring her account to Josephthal. Even assuming, as Stein contends, that EA sought to speculate, Stein concentrated EA's account too highly in speculative securities. By the end of 1994, Stein had invested 43 percent of EA's account in speculative securities. That percentage had increased to 90 percent by the end of 1995. Indeed, during the first quarter of 1996, AGC, a speculative mining stock, constituted 59 percent of her portfolio. Based on the concrete information available to Stein regarding EA's financial status, we find that the investment strategy that Stein recommended for EA resulted in EA's investing in stocks that were too risky for someone with her modest income and net worth and that Stein concentrated an excessive portion of EA's portfolio in a non-diverse, limited number of speculative securities, thereby increasing EA's risk of loss. See Stephen Thorlief Rangen, 52 S.E.C. 1304 (1997) (concentration of equity in particular securities increases risk of loss beyond what is consistent with the objective of safe, non-speculative investing); Clinton Hugh Holland, Jr. 52 S.E.C. 562 (1995) (concentration of high risk and speculative securities and shift of portfolio from conservative to speculative investments was not suitable), aff'd, 105 F.3d 665 (9th Cir. 1997) (table format).

Stein argued that EA understood the risks associated with speculative investments and that she actively sought to change her investment strategy to one that involved growth and speculation.[13] Even if we concluded that EA understood Stein's recommendations and decided to follow them, "that [would] not relieve [Stein] of his obligation to make reasonable recommendations." Holland, supra at 566. The test for whether Stein's recommended investments were suitable is not whether EA considered the investments to be suitable, but whether the recommendations were consistent with her financial situation and needs. Rangen, supra; Gordon Scott Venters, 51 S.E.C. 292 (1993); Eugene Erdos, 47 S.E.C. 985 (1983), aff'd 742 F.2d 507 (9th Cir. 1984). As discussed above, we find that they were not.

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transactions irrelevant to suitability determination). If, as Stein contends, EA was not completely forthcoming as to her financial situation, Stein "had a duty to proceed with caution; to make recommendations only on the basis of the concrete information that [EA] did supply and not on the basis of guesswork as to the value of other possible assets." Eugene C. Erdos, 47 S.E.C. 985, 988 (1983), aff'd, 742 F.2d 507 (9th Cir. 1984).

[13] Stein also contended that EA was a sophisticated investor because she read financial periodicals and books and that she kept abreast of financial news. Based on the record, however, it does not appear that EA was sophisticated. See Venters, supra (SEC rejected argument that investor who read financial articles was a sophisticated investor). Stein also argued that Enforcement over-estimated the amount of EA's losses and that she would have lost less or made money if she had held onto her AGC stock as he had recommended. Unsuitable recommendations, however, are not made suitable because they result in a profit. Larry Ira Klein, 52 S.E.C. 1030, 1037 n. 29 (1996); Erdos, supra, at 988 n. 10.

Stein's recommended use of margin trading in EA's account also made the investments unsuitable. "Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently. . . . Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain." Rangen, 52 S.E.C. at 1307-08. Even if EA understood the risks associated with margin trading and chose, notwithstanding the risks, to pursue it, we do not find that EA's financial situation and investment objectives substantiated the increased risk to which Stein's margin trading exposed EA's account. See David A. Gingras, 50 S.E.C. 1286 (1992) (impropriety of recommended trading strategy exacerbated by use of margin to trade in customer account); Charles W. Eye, 50 S.E.C. 655, 659 (1991) ("[R]egardless of whether [the client] appeared willing, or even eager, to pursue 'growth' as Eye understood it, it was Eye's duty to advise her against that pursuit to the extent that it was incompatible with her acknowledged needs.").

Finally, Stein's recommended investments in EA's account were unsuitable because of the excessive number of trades in EA's account.[14] While there is no single test for making an excessive trading determination, the turnover rate[15] and the number and frequency of trades in an account introduce some measure of objectivity or certainty into the analysis and provide a basis for a finding of excessive trading. Harry Gliksman, Exchange Act Rel. No. 42255 (Dec. 20, 1999); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 435-36 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970); Clyde J. Bruff, 53 S.E.C. 880 (1998), pet. denied, 198 F.3d 253 (9th Cir. 1999).

Turnover rates between three and five have triggered liability for excessive trading,[16] and the courts and the SEC have held that there is little question about the excessiveness of trading

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[14] There is no dispute that Stein recommended the majority of trades in EA's account and that EA routinely followed Stein's investment advice.

[15] The turnover rate is calculated by applying the "Looper Formula," named after Looper & Co., 38 S.E.C. 294 (1958), which divides the total cost of purchases made during a given period by the average monthly investment. See Frederick C. Heller, 51 S.E.C. 275, 276-77 (1993). The turnover rate is computed "by dividing the aggregate amount of the purchases by the average cumulative monthly investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." Id. at 279 n.10. In accounts opened principally with securities rather than a cash deposit, a modified Looper formula, which divides the total cost of purchases by the average monthly equity, is appropriate. See Allen George Dartt, 48 S.E.C. 693 (1987).

[16] Donald A. Roche, 53 S.E.C. 16, 21-22 (1997) (finding that turnover rates of 3.3, 4.6 and 7.2 provided strong support for finding of churning); Gerald E. Donnelly, 52 S.E.C. 600, 602 n. 11 (1996) (noting that respondent acknowledged that "an annualized turnover rate of between two and four percent is presumptive of churning"); Michael H. Hume, 52 S.E.C. 243, 245 n.5 (1995) (noting that turnover rates of 3.5 and 4.4 were found to be excessive in past cases); John

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when an annual turnover rate in an account is greater than six.[17] Here, the staff examiner calculated annualized turnover rates for the period when Stein handled EA's account at Josephthal (March 1994 through April 1996) to be 5.12, which means that Stein sold every stock in EA's portfolio roughly every ten weeks. Although this turnover rate is less than six, we find it to be excessive. During 1995 alone, the turnover rate in EA's account was 7.63. Furthermore, during the most active period in the account (November 1994 through March 1996), the annualized turnover rate was 11.96.

In sum, Stein was obligated to tailor his recommendations to EA's financial situation and needs. Gingras, supra. Stein's recommendations to EA did not meet his obligation to make customer-specific determinations of suitability in terms of the types of securities, the concentration of securities, the use of margin, and the number of transactions. Stein's recommendations to customer EA between March 1994 and April 1996 and from January through November 1997 were unsuitable and violated Conduct Rules 2110 and 2310.

Sanctions

In light of our findings, we fine Stein $25,000 and suspend him from associating with any member firm in any capacity for a period of three months.[18]

We find Stein's misconduct to be serious and deserving of significant sanctions. During a period of over two years, Stein encouraged EA to convert her relatively safe investment portfolio into a portfolio of risky and speculative stock purchases that were highly unsuitable for a mature

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M. Reynolds, 50 S.E.C 805, 808 n.12 (1992) (finding excessive trading, in part, based on the fact that the account was turned over more than four times on an annualized basis); Samuel B. Franklyn & Company, 42 S.E.C. 325, 330 (1964) (finding turnover rates of 3.5 and 4.4 to be excessive); R.H. Johnson & Co., 36 S.E.C. 467, 469-80 (1955) (finding turnovers of 3.26 to 11.1 annually to be excessive).

[17] See, e.g., Peter C. Bucchieri, 52 S.E.C. 800, 805 (1996) ("While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading."); Shearson Lehman Hutton Inc., 49 S.E.C. 1119, 1122 (1989) (same).

[18] The sanctions that we have imposed are consistent with the ranges recommended in the NASD Sanction Guidelines ("Guidelines") (1998 ed.) at 74 (Churning or Excessive Trading); 83 (Suitability -- Unsuitable Recommendations).

We reduce the one-year suspension that the Hearing Panel imposed to three months in light of our finding that the periods of violation were shorter than the Hearing Panel had found and to be consistent with the applicable Guidelines. Additionally, with respect to sanctions, we considered Stein's settlement with EA, the fact that EA regularly received confirmations and received at least two activity letters inquiring as to EA's satisfaction with her account, and EA's failure to complain until her account lost value.

widow of modest means. Stein concentrated EA's account predominantly in high-risk securities, and he recommended that she use margin to trade, thereby increasing the risks associated with her investments. During the time Stein controlled EA's Josephthal account, a period of just over two years, Stein traded EA's account excessively. EA paid $32,095 in commissions and incurred margin interest of $6,969.89. Together, the commissions and margin interest that EA paid equaled approximately $39,000 for an account that was valued at $78,000 when she transferred it to Stein. In our view, the sanctions of a $25,000 fine and a three-month suspension are appropriately remedial in light of the misconduct at issue.

Accordingly, Stein is fined $25,000 and suspended for three months in all capacities.[19]

On Behalf of the National Adjudicatory Council,

Jeffrey S. Holik
Senior Vice President and Acting General Counsel

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

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