BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

| In the Matter of<br><br>District Business Conduct Committee for District No. 1,<br><br>Complainant,<br><br>vs.<br><br>Respondent 1<br><br>and<br><br>Respondent 2<br><br>Respondents. | DECISION<br><br>Complaint No. C01950021<br><br>District No. 1<br><br>Dated: August 28, 1997 |
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Respondent 1 and Respondent 2 have appealed, pursuant to NASD Procedural Rule 9310, a January 23, 1997, decision of the District Business Conduct Committee for District No. 1 ("DBCC"). We find that Respondent 1 violated Conduct Rules 2110, 2310 and 2120 by making unsuitable recommendations and using a deceptive and fraudulent device in the sale of securities, and we order that he be censured, fined $74,105, and barred in all capacities from associating with any member of the Association. We reverse the DBCC's finding that Respondent 2 violated Conduct Rule 3010 by failing to exercise adequate supervision of Respondent 1, and we therefore set aside all sanctions imposed against Respondent 2.

Factual Background

From December 1980 to November 5, 1990, Respondent 1 was employed by Firm A (or "the Firm"), as a general securities representative and principal. From November 1990 to May 21, 1991, Respondent 1 was employed by Firm B, as a general securities representative and principal. From July 1991 to September 4, 1992, Respondent 1 was employed by Firm C, as a general securities representative and principal. Respondent 1 is not currently associated with any member of the Association.

Respondent 2 entered the securities industry in 1964. From 1964 to 1976 and again from May 1978 through the present, Respondent 2 has been employed by Firm A. Respondent 2 has been and continues to be

registered with the Association as a general securities representative and principal.

Firm A's supervisory system placed primary responsibility for ensuring compliance upon the Administrative Manager of each branch office. The Administrative Manager received and was responsible for reviewing daily printouts of sales activity called "Form 1028." When the Firm's centralized computer system identified accounts that exceeded certain parameters for the number of transactions and commissions charged, the compliance department advised the Administrative Manager at the branch office to complete an activity review sheet called "Form 1035," identifying the particular client account and the number of trades or commissions that might raise concerns. The Administrative Manager and the broker on the accounts each completed part of the Form 1035. The Administrative Manager would then review the report and determine which accounts should be brought to the Resident Vice President's attention.

From February 1989 through November 1990, a person was employed as the Administrative Manager of one of Firm A's offices. As such, he was Respondent 1's direct supervisor. From April 1989 to November 5, 1990, Respondent 2 was the Resident President in charge of Firm A's branch office complex, replacing CP as Firm A's Administrative Manager's direct supervisor.

In June 1986, Respondent 1 opened a single-ownership account ("Single Account") for Customer MB with Firm A. The new-account form for the Single Account indicates that at the time the account was opened Customer MB was an unemployed widow, with $20,000 in annual income, and net worth totaling $300,000. Her investment objectives were long-term price appreciation and income.

In October 1988, Firm A's Administrative Manager became concerned about Respondent 1's handling of Customer MB's Single Account, specifically with his frequent liquidation of mutual fund positions. Firm A's Administrative Manager communicated these concerns to an officer in compliance department. Firm A's Administrative Manager refused to sign off on the October 1988 monthly activity review generated for the Single Account. Instead, he referred it to CP. Firm A's Administrative Manager assumed that CP later met with Respondent 1 to discuss the account activity.

On February 2, 1989, the a County Superior Court appointed Respondent 1 as Customer MB's conservator. The next day, Respondent 1 attempted to open a second account for Customer MB, with himself designated as conservator and broker ("Conservatorship Account"). When the Conservatorship Account was opened, the notation for annual income was left blank, and Customer MB's net worth was listed as $500,000. The investment objectives remained long-term price appreciation and income.

Firm A's Administrative Manager recognized the inherent conflict of interest in Respondent 1's acting as conservator for the account, while also acting as the broker. Firm A's Administrative Manager sought advice from Firm A's compliance counsel, who instructed that the account be opened with Respondent 1 as conservator and Firm A's Administrative Manager as the financial consultant in charge of the account.[1] Firm A's

[1] Firm A's compliance counsel was unaware that Firm A's Administrative Manager had earlier expressed

Administrative Manager understood that Respondent 1 would close the Single Account, due to Customer MB's inability to control her own affairs, and that the only activity to be conducted in the Conservatorship Account was the sale of mutual funds. Firm A's Administrative Manager did not participate in any investment decisions for the Conservatorship Account, and his share of commissions earned on the account was negligible. Respondent 1 maintained complete discretion over the Conservatorship Account.

Rather than closing the Single Account, Respondent 1 began a cycle in which he: (1) purchased securities in the Single Account; (2) journaled the securities into the Conservatorship Account; (3) then sold the securities; and (4) transferred the proceeds back into the Single Account to begin the cycle again. There were approximately 78 purchase transactions in the Single Account between January 1989 and December 1990. Securities purchased and sold in the Single Account were held for five to 145 days. There were 38 sale transactions out of the Conservatorship Account. Securities purchased in the Single Account and then sold from the Conservatorship Account were held for 20 to 252 days. Respondent 1 made no purchases in the Conservatorship Account. Based on the modified Looper formula, the annualized turnover rate in the Single Account during this period was 6.94. The combined activity in the Conservatorship and Single Accounts had an annualized turnover rate of 2.73. Respondent 1's commissions from Customer MB's Firm A accounts during 1989 and 1990, totaled $22,893.09.

As the designated financial consultant on the Conservatorship Account, Firm A's Administrative Manager received daily reports relating to the account. Firm A's Administrative Manager knew of activity in the Single Account and had discovered Respondent 1's transfer of investments and cash from one account to the other. Nevertheless, Firm A's Administrative Manager never again called Firm A's compliance counsel to discuss Respondent 1's activities or the Customer MB accounts. Firm A's Administrative Manager never told Respondent 2 anything about the Conservatorship Account; that Respondent 1 was Customer MB's conservator; or that Respondent 1 used two accounts to facilitate the transactions.

Although monthly activity reviews were generated for the Single Account, in January, March, and April 1989, Firm A's Administrative Manager did not recall signing any of them. Nor did he recall bringing his concerns about the account to Respondent 2 after Respondent 2 replaced CP. Firm A's Administrative Manager did not bring these matters to Respondent 2's attention, because Firm A's Administrative Manager assumed that the compliance office began monitoring Customer MB's accounts after he contacted them in February 1989. This assumption was incorrect. Firm A's Administrative Manager's pre-existing relationship with Respondent 1 and his lack of familiarity with Respondent 2 also influenced his failure to keep Respondent 2 fully informed.

In late May or early June of 1989, Firm A's Administrative Manager told Respondent 2 that

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concerns about Respondent 1's handling of the Single Account. Firm A's compliance counsel testified that he would not have allowed Respondent 1 to open the Conservatorship Account had Firm A's compliance counsel known of Firm A's Administrative Manager's earlier concerns.

Respondent 1 had been switching mutual funds in the Single Account. At that time, Respondent 2 had been working in the branch office for three months and did not know that Respondent 1 had been appointed Customer MB's conservator or that the Single Account should have been closed.

Based on his conversation with Firm A's Administrative Manager, Respondent 2 confronted Respondent 1 about the mutual fund switching. Respondent 1 misinformed Respondent 2 that he had discussed the switching with Customer MB and her accountant, and explained that the changes were based on tax considerations. Respondent 2 accepted Respondent 1's explanation, but warned Respondent 1 that he would fire Respondent 1 if there was any further fund switching. Respondent 2 memorialized that conversation in a handwritten note on a monthly activity review for the Customer MB Conservatorship Account, and informed Firm A's Administrative Manager about this conversation with Respondent 1.

Early in August of 1989, Respondent 1 asked Respondent 2 to initial an order ticket for the redemption of mutual funds. Concerned about the possibility of renewed mutual fund switching, Respondent 2 required Respondent 1 to confirm that the proceeds would not be reinvested in other mutual funds. Respondent 2 memorialized Respondent 1's confirmation by noting on the order tickets: "Not reinvesting in funds."

Respondent 2 terminated Respondent 1 from Firm A in November 1990, for conduct unrelated to this case.

Respondent 1 then transferred his registration to Prudential, where he re-opened a Customer MB Conservatorship Account. Respondent 1 made 39 purchases and 37 sales between December of 1990 and May of 1991, for an annualized turnover rate of 5.26. Respondent 1 earned $12,687.31 in gross commissions from Customer MB's Prudential account. Respondent 1 left Prudential in September 1991, and he transferred the Customer MB account to two new accounts at another brokerage firm ("Firm C"). The annualized turnover rates for the two Customer MB accounts at Firm C from August 1991 to September 1992, were 3.65 and 6.07. There were 47 purchases, 43 sales, and Respondent 1 earned $13,524.76 in commissions.

In early 1993, Firm C filed a Form U-5 with the Association indicating that Respondent 1 had been terminated for improper activity in Customer MB's accounts. The Association's investigation of Respondent 1's termination led to the July 24, 1995 issuance of the five-cause complaint in this matter alleging that Respondent 1 violated Conduct Rules 2110, 2310, and 2120, and that Respondent 2 and Firm A's Administrative Manager [2] violated Conduct Rules 2110 and 3010.[3]

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[2] Firm A's Administrative Manager submitted an Offer of Settlement to resolve the allegations in the complaint against him. Without admitting or denying those allegations, Firm A's Administrative Manager agreed to findings that he had failed to supervise Respondent 1 properly, and to sanctions consisting of a censure, a $7,500 fine, and a requirement that he requalify as a general securities sales supervisor prior to acting again in a supervisory capacity. The Association accepted Firm A's Administrative Manager's Offer of Settlement and, therefore, Firm A's Administrative Manager's conduct is not under review.

Discussion

After thoroughly reviewing the record and for the reasons discussed below, we find that Respondent 1 violated Conduct Rules 2110, 2310, and 2120 by excessively trading in the account of Margaret Customer MB, and by engaging in a fraudulent scheme to generate commissions, while employed at three member firms. We further find that Respondent 2's supervision of Respondent 1 did not violate Conduct Rule 3010, and we therefore dismiss cause two against Respondent 2 and eliminate all sanctions imposed against him.

Respondent 1. Conduct Rule 2310 requires that representatives have a reasonable basis for recommending purchases and sales to their customers and prohibits representatives from engaging in excessive trading, often referred to as "churning," in customer accounts. See IM 2310-2. Excessive trading is determined by calculating the annual turnover rate of the assets in a customer account. The turnover rate is calculated by applying the 'Looper formula," named after In re Looper and Co., 38 S.E.C. 294 (1958), which divides the total cost of purchases made during a given period by the average monthly investment. A modified Looper formula divides the total cost of purchases by the average monthly equity. In re Allen George Dartt, 48 S.E.C. 693 (1987); Report of the Special Study of the Options Markets to the Securities and Exchange Commission, H.R. Com. Print IFC3, 96th Cong., 1st Sess. (1978).

Customer MB's accounts had an excessive turnover rate. Based on the modified Looper formula, the annualized turnover rate in the Single Account at Firm A from January 1989 to December 1990 was 6.94. From December 1990 to May 1991, the annualized turnover rate was 5.26 in Customer MB's Prudential account. From August 1991 to September 1992, the annualized turnover rates in Customer EJ's accounts were 3.65 and 6.07. The Commission has repeatedly stated that there is no "magical" annual percentage which definitively establishes excessive trading. See, e.g., In re Peter C. Bucchieri, Exchange Act Rel. No. 37218 (May 14, 1996); In re Gerald E. Donnelly, Exchange Act Rel. No. 36690 (Jan. 5, 1996). It is clear, however, that turnover rates between three and four have triggered liability for excessive trading. Donnelly (turnover rates of 3.7 and 4.4); In re Samuel B. Franklin & Co., 42 S.E.C. 325 (1964) (turnover rates of 3.5 and 4.4 are excessive). By this measure, Respondent 1's trading in Customer MB's accounts was clearly excessive.

The turnover rates in Customer MB's accounts are particularly troubling in light of Respondent 1's complete control over the accounts. In fact, they were Customer MB's accounts in name only, Respondent 1 was the conservator of three of the accounts, and Customer MB clearly lacked the ability to control trading in the others. Control over a customer's account is an important element in a "churning" analysis. See Donnelly (Commission considered Donnelly's "extensive control" over customers' accounts); In re Michael H. Hume,

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[3] The fifth cause of the complaint alleged that from December 1991 to July 1992, Respondent 1 recommended to public customer GW purchases and sales of securities that were unsuitable for her, thereby violating Conduct Rules 2110 and 2310. The evidence does not support a finding of violation with respect to cause five and we affirm the DBCC's dismissal of cause five.

Exchange Act Rel. No. 35608 (Apr. 17, 1995) (customers followed Hume's recommendations completely); In re Frederick C. Heller, 51 S.E.C. 275, 277 (1993) (trading pattern changed when clients began traveling full-time).

Respondent 1's trading also was inappropriate for Customer MB in light of her financial condition and investment goals. According to the new account form for the Firm A Single Account, Customer MB was an unemployed widow, with income of $20,000 per year, and net worth totaling $300,000. Her investment objectives were long-term price appreciation and income, and she preferred investment grade or good quality investments. The high turnover and short-term strategies that Respondent 1's used were inconsistent with Customer MB stated goals and preferences. This inconsistency widened with each passing year that Respondent 1's controlled Customer MB accounts.

Respondent 1's scheme was a deceptive and fraudulent device or contrivance carried out with scienter, in violation of Conduct Rule 2120. Scienter is the mental state of knowingly or recklessly intending to deceive, manipulate, or defraud. Ernst & Ernst v. Hochfelder, 425 U.S.185, 193-94 (1976). Respondent 1 knew that Customer MB was no longer competent to manage her affairs or to consent to Respondent 1's trading, yet Respondent 1 continued to trade in Customer MB Single Account. Respondent 1 used two accounts in an attempt to conceal conduct that he knew the Association and his employers prohibited. He did so with the intent and effect of defrauding a customer to whom he owed a fiduciary duty as her court-appointed conservator. There is no plausible justification for Respondent 1's conduct.

Respondent 1, in his answer to the complaint and in responses to an Association questionnaire, made several claims: (1) that prior to his appointment as conservator for Customer MB, he received approval both from Customer MB and her husband before carrying out any transactions in the Single Account; (2) that the activity in both of the accounts from 1989 to 1992 was consistent with Customer MB's investment objectives; and (3) that due to the lapse in time between the events in question and the filing of the complaint, Respondent 1 was missing documents that were necessary to his defense. These claims are unsupported by the record. Respondent 1's argument that he, as Customer MB's sole heir, would eventually have borne any losses incurred in the accounts, is immaterial.[4]

Based upon the foregoing, we find that Respondent 1 deceptively and excessively traded in the accounts of Customer MB in violation of Conduct Rules 2310 and 2120. We further find that such conduct is inconsistent with high standards of commercial honor and just and equitable principles of trade in violation of Conduct Rule 2110.

Respondent 2. Respondent 2 is charged with failing adequately to supervise Respondent 1, in violation

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[4] Although he answered the complaint, Respondent 1 did not attend either session of the DBCC hearing. Nor did he participate in the appeal hearing, despite filing a notice of appeal and being informed that he could participate by telephone.

of Conduct Rule 3010. Conduct Rule 3010 requires a member to establish, maintain, and enforce a supervisory system with written procedures. Each registered representative must be adequately monitored by a supervisor. The standard by which to judge the reasonableness of Respondent 2's conduct is based on the particular circumstances of each case. See In re Consolidated Investment Services, Inc., Exchange Act Rel. No. 36687 (Jan. 5, 1996); In re Rita H. Malm, Exchange Act Rel. No. 35000 (Nov. 23, 1994). The primary issue on appeal is whether there were "red flags" sufficient to conclude that Respondent 2 knew or should have known of Respondent 1's misconduct. The record establishes that there were not.

It was reasonable for Respondent 2 to rely on Firm A's Administrative Manager to notify him of Respondent 1's misconduct. Firm A's compliance system called for Firm A's Administrative Manager, as Respondent 1's Administrative Manager, to review Respondent 1's Forms 1028 and 1035, and to bring irregularities to the Resident Vice-President's (Respondent 2) attention. When Respondent 2 became Resident Vice-President for the office, Firm A's Administrative Manager had a reputation at Firm A for being conscientious and compliance-oriented. Respondent 2 knew that Respondent 1 was an experienced representative and former Administrative Manager with no disciplinary history. Respondent 2 had no reason to be suspicious of Firm A's Administrative Manager 's or Respondent 1's conduct.

Firm A's Administrative Manager, beyond simply being aware of Respondent 1's fraudulent conduct and failing to reveal it to Respondent 2, affirmatively hindered Respondent 2's ability properly to supervise Respondent 1. In May or June of 1989, Firm A's Administrative Manager approached Respondent 2 and raised the red flag that Respondent 1 was engaged in mutual fund switching in Customer MB's Single Account. Respondent 2 quickly and effectively dealt with this problem and, going forward, was continuously sensitive to Respondent 1's proclivity towards mutual fund switching. We find that, by focusing Respondent 2's attention on the problem of mutual fund switching, Firm A's Administrative Manager distracted Respondent 2 from Respondent 1's fraudulent scheme and led Respondent 2 to believe that Firm A's Administrative Manager was conscientiously monitoring Respondent 1's conduct.

These circumstances explain Respondent 2's failure to request and review copies of account statements from Customer MB's Single Account or to discover the Conservatorship Account, two facts that the DBCC found problematic. Had Respondent 2 requested and reviewed documents from the Single Account, he probably would have unearthed Respondent 1's fraudulent conduct. At the time, however, it was Firm A's Administrative Manager 's responsibility to bring to Respondent 2's attention any documents necessary to deal with the problem that Firm A's Administrative Manager identified. This called for Firm A's Administrative Manager to reveal his own dereliction, which he apparently chose not to do. Respondent 2 claims that had Firm A's Administrative Manager properly informed him of Respondent 1's conduct, Respondent 2 would have dealt with Respondent 1 severely. Based upon Respondent 2's June 1989 meeting with Respondent 1 and his later firing of Respondent 1, we find this claim both credible and creditable.

In sum, Respondent 2 did not fail to exercise adequate supervision over Respondent 1. Accordingly, we reverse the DBCC's finding of violation, dismiss cause two with respect to Respondent 2, and eliminate all sanctions imposed against Respondent 2.

Sanctions

Respondent 1's conduct in this case was deplorable. Rather than fulfilling his fiduciary duty to Customer MB, he repaid the trust she placed in him by defrauding and cheating her. He did so knowingly, over an extended period of time, while she was defenseless. There can be no doubt that Respondent 1 is not fit to remain associated with the securities industry.[5]

Based on the foregoing, it is ordered that: Respondent 1 be censured, fined $74,105.00, barred from association with any member of the Association in any capacity, and assessed $766 in costs for the DBCC's hearing.[6] The bar of Respondent 1 is effective immediately upon the issuance of this decision.[7]

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

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[5] We have considered all the arguments of the parties. They are sustained to the extent they are in accord with the views expressed herein, and otherwise rejected.

[6] This sanction includes fining away all commissions earned by Respondent 1 from the activity in the Customer MB accounts, and adding $25,000. These sanctions are consistent with the applicable NASD Sanction Guidelines ("Guidelines"). Guidelines (1993 ed.) at 29 and 43 (Misrepresentations and Suitability).

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