BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. VMR Capital Markets US Beverly Hills, CA, and Todd M. Ficeto Malibu, CA, Respondents.	DECISION Complaint No. C02020055 Dated: December 2, 2004

Respondents failed to reasonably supervise a registered representative who engaged in excessive and unsuitable trading in three customer accounts. Held, findings affirmed and sanctions modified.

APPEARANCES

For the Complainant NASD Department of Enforcement: Sylvia M. Scott, Esq., and Leo F. Orenstein, Esq.

For the Respondents: Erwin J. Shustak, Esq., and Teresa M. Gillis, Esq.

DECISION

VMR Capital Markets US ("VMR Capital Markets" or "the Firm") and Todd M. Ficeto ("Ficeto") appeal this matter pursuant to NASD Procedural Rule 9311. The Hearing Panel found that, from September 2000 to January 2001, VMR Capital Markets and Ficeto failed to reasonably supervise a registered representative who engaged in excessive and unsuitable trading in three customer accounts in violation of NASD Conduct Rules 3010 and 2110. The Hearing Panel fined respondents $25,000, jointly and severally, and suspended Ficeto in all supervisory capacities for 15 business days. The Hearing Panel also assessed $2,548.69 in costs against respondents, jointly and severally. We affirm the Hearing Panel's findings. As for sanctions, we affirm the suspension imposed on Ficeto, but we increase the fine imposed on respondents to $40,000. We also affirm the costs imposed and assess appeal costs.

I. Background

A. VMR Capital Markets

VMR Capital Markets, a general securities broker-dealer previously known as Century City Securities, Inc. and currently known as Hunter World Markets Inc., has been an NASD member since March 25, 1996. VMR Capital Markets is jointly owned by Ficeto and a German company. The Firm has never had more than 10 sales representatives, and during the relevant period it employed approximately six to 10 representatives in one office. Although the Firm generated the overwhelming majority of its revenues from institutional sales, the Firm also engaged in retail sales of stocks.

B. Ficeto's Employment History

Ficeto entered the securities industry in January 1989 as an investment company products/variable contracts representative with another member firm. He has been the president and compliance officer of VMR Capital Markets since March 1996. During the time of the alleged misconduct, Ficeto was registered with the Firm as a general securities principal, a general securities representative, and an equity trader.

C. Procedural History

On November 19, 2002, the Department of Enforcement ("Department") issued a complaint charging that VMR Capital Markets and Ficeto failed to supervise Kert St. John ("St. John"), a registered representative at the Firm, in violation of Conduct Rules 3010 and 2110. The complaint alleged that, from September 2000 to January 2001, St. John engaged in unsuitable trading in, and exercised discretionary power without prior written authorization over, three customer accounts. On January 13, 2003, respondents filed an answer, in which they generally denied the allegations, set forth several affirmative defenses, and requested a hearing. On June 24 and 25, 2003, a Hearing Panel conducted an evidentiary hearing.

On September 24, 2003, the Hearing Panel issued its decision. In its findings of fact, the Hearing Panel found that, during the relevant period, St. John actively traded unsuitable securities for three customer accounts, Ficeto was responsible for supervising St. John, and Ficeto did not delegate reasonably and effectively his supervisory responsibility to anyone else. The Hearing Panel also concluded that, assuming *arguendo* that Ficeto delegated supervisory responsibility to Firm employee David Ludwig ("Ludwig"), such delegation was not effective for two reasons: (1) Ludwig was not permitted under Membership and Registration Rule 1021 to function as a general securities principal between November 6, 2000, and January 23, 2001, given his failure to pass the general securities principal qualification examination (Series 24); and (2) Ficeto did not give Ludwig the necessary authority to carry out supervisory responsibilities. Finally, the Hearing Panel found that Ficeto did little to curtail St. John's unsuitable trading activities. In light of these findings, the Hearing Panel concluded that Ficeto and VMR Capital Markets failed reasonably to supervise St. John.

II. Facts

A. St. John's Trading Activities

In late August 2000, Ficeto hired St. John as a general securities representative in the Firm's retail department. Prior to joining VMR Capital Markets, St. John was a registered representative for CUNA Brokerage Services ("CUNA") in Yuma, Arizona, where, according to St. John's resume, he was responsible for working with credit union members. St. John's previous experience involved working with mutual funds, annuities and insurance products, but he had no experience trading stocks. Ficeto testified that he knew St. John came from a "mutual fund background."

On August 30, 2000, just days after St. John joined the Firm, he transferred the accounts of three of his CUNA customers: JB, RC and ES. Ficeto approved the opening of all three accounts. By early October 2000, these customers' assets were transferred to their accounts with VMR Capital Markets.

Of the three customers, JB had the most conservative investor profile. JB's new account form indicated that, when she transferred her account to the Firm, she was 80 years old, retired, and had a net worth of $130,000 and an annual income of $20,000. JB's account opening form stated that her investment objectives were "income," "safety of principal" and "tax free/deferred," and that her risk tolerance was "low." JB's form also disclosed that she had no experience trading stocks, bonds or options, and "little" experience trading funds.[1] In a written declaration, JB stated that "I repeatedly told St. John that I depended on my account for my living expenses," "clearly told him to invest only in conservative mutual funds," and "told him on at least two occasions that I did not want to buy individual stocks."

RC's profile also was that of a conservative investor. RC's account opening document indicated that, when she transferred her account to the Firm, she was 80 years old, retired, and had a net worth of $400,000 and an annual income of $30,000. RC identified her investment objectives as "income" and "growth," and her risk tolerance level as "moderate." RC's account opening form also indicated that she had "little" experience trading stocks and bonds, and "moderate" experience trading funds.

ES opened a new individual retirement account at the Firm. According to her account opening form, ES was 48 years old, had an annual income of $60,000, and had a net worth of $250,000. The form indicated that ES's investment objective was "growth" and her risk tolerance was "moderate." The document further disclosed that ES had "moderate" experience trading stocks and funds, and "little" experience trading bonds.

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[1] The account opening form has four categories of investment experience: "none," "little," "moderate" and "extensive." In addition, the form lists three levels of risk tolerance: low, moderate and high.

According to Department witness Eugene Horwitz ("Horwitz"), an NASD special investigator, JB, RC and ES engaged in little to no trading activities while with CUNA.[2] At CUNA, JB "bought a few mutual funds" but otherwise engaged in "[v]irtually no trading." Similarly, RC's CUNA account statements show that she "just had a few trades in mutual funds," followed a "buy[ ] and hold[ ] strategy," and had "[n]o stock trading at all." ES engaged in "very, very moderate low-level stock trading [at CUNA]," but generally invested in mutual funds and followed a "buy-and-hold kind of strategy." In a written declaration, ES stated she "believed that St. John would continue the investment pattern that [she] had employed at CUNA."

The nature of the trading activity in these customers' accounts changed dramatically upon being transferred to VMR Capital Markets. Within a short period of time, St. John liquidated most of the mutual fund holdings in the accounts and began buying and selling stocks, frequently selling individual stocks within days of purchasing them. From late September 2000 through January 2001, St. John's trades in all three accounts reflected extremely high levels of turnover: (i) in JB's account, 55 trades at a turnover ratio of 51.35; (ii) in RC's account, 97 trades at a turnover ratio of 59.46; and (iii) in ES's account, 101 trades at a turnover ratio of 38.88.[3] Furthermore, the amount of commissions generated by these trades made it highly unlikely that these customers would break even, given the levels of equity in their accounts: (i) JB paid $8,840 in commissions, at a commission-to-equity ratio of 64.50%; (ii) RC paid $18,383.75 in commissions, at a commission-to-equity ratio of 59.93%; and (iii) ES paid $19,933.86 in commissions, at a commission-to-equity ratio of 47.36%.[4]

In addition to making excessive trades for these three customers, St. John purchased for them qualitatively unsuitable securities. Specifically, St. John purchased shares of Stan Lee

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[2] Like their account opening documents with VMR Capital Markets, these customers' account opening documents at CUNA reflected conservative investor profiles.

[3] The turnover ratio represents "the number of times during the year that the securities in an account are replaced by new securities." *Edgar B. Alacan*, Exchange Act Rel. No. 49970, 2004 SEC LEXIS 1422, at *30 (July 6, 2004). To calculate the turnover ratio, Horwitz divided the average monthly purchases by the average "beginning [monthly] equity," and multiplied by 12 to arrive at an annualized ratio. *Cf. Dep't of Enforcement v. Howard*, Complaint No. C11970032, 2000 NASD Discip. LEXIS 16, at *20 n.18 (NAC Nov. 16, 2000) (explaining formulas for calculating turnover ratios), *aff'd*, *Daniel Richard Howard*, Exchange Act Rel. No. 46269 (July 26, 2002).

[4] The commission-to-equity ratio represents the percentage return on the customer's average net equity needed to pay commissions and other expenses. *Howard*, 2000 NASD Discip. LEXIS 16, at *21. In other words, the ratio reflects how much the account would need to appreciate to break even. *Id.* To calculate the commission-to-equity ratio, Horwitz divided the average monthly commissions paid by the average "beginning [monthly] equity," and multiplied by 12 to arrive at an annualized ratio.

Media, in which the parent company of VMR Capital Markets held a minority stake.[5] The Firm's own research report indicated that Stan Lee Media was "only suitable for high-risk, high-rewards accounts."

Although St. John did not have discretionary authority to trade these three accounts, he made trading decisions as if he did. By the end of January 2001, JB had lost $9,691.92, RC had lost $31,835.79, and ES had lost $21,542.72.[6] In July 2001, JB filed a customer complaint with NASD concerning St. John, triggering NASD's investigation.[7]

B. Ficeto's Supervisory Responsibility over St. John

During the entire period of time relevant to the complaint, Ficeto served as the Firm's president and compliance officer. As president, Ficeto's primary duties included managing the Firm's investment banking and institutional sales activities, and monitoring the Firm's commissions. Ficeto also had overall responsibility for the Firm's compliance functions, including ensuring that the Firm's written supervisory procedures ("WSPs") were implemented.

Prior to May 2000, Ficeto and the Firm had delegated the authority to supervise the retail unit to Jose Abadin ("Abadin"). At some point in 2000, however, Abadin began to make a transition to the institutional sales side of the Firm. Ficeto testified that, to facilitate Abadin's move, he and Abadin jointly supervised the retail representatives in May or June 2000. Abadin testified that he "relinquished" his retail supervisory position sometime around June 2000, before St. John joined the Firm.[8]

Ficeto, who daily reviewed the trading activity and commissions and observed St. John submitting numerous order tickets, was aware of potential problems in St. John's accounts. Ficeto admitted that the high volume of St. John's trading activities "stood out like a sore thumb" and was "dramatic[ally]" different from the other brokers' activity. Ficeto conceded that he was aware of potential suitability and excessive trading problems in St. John's accounts as early as

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[5] Between September 28 and October 10, 2000, St. John purchased 500 shares of Stan Lee Media for JB, 2,000 shares for RC, and 2,000 shares for ES.

[6] As of January 31, 2001, JB's account balance was $49,353.74, RC's account balance was $117,179.33, and ES's account balance was $107,804.23.

[7] On November 19, 2002, St. John settled allegations that he: (i) engaged in unsuitable trading; and (ii) exercised discretionary power without the customers' written authorization and the Firm's written acceptance of the accounts as discretionary.

[8] Abadin testified that the WSPs inaccurately identified him as the designated supervisor over the Firm's retail, trading and market-making activities as of August 2000.

November 2000 and admitted that he was specifically aware that St. John was trading "tech stocks" in the accounts of JB and RC, who "were elderly and [had] less risk tolerance."[9]

As St. John's supervisor and compliance officer, Ficeto had supervisory powers and responsibilities that were relevant to the situation concerning St. John's trading. Ficeto made all hiring and firing decisions at the Firm, and he admitted he had the ability to investigate and place limitations on St. John's activities. Moreover, the Firm's WSPs — which Ficeto was responsible for implementing — spelled out Ficeto's supervisory responsibilities. The WSPs required the Firm's compliance department to, "on a quarterly basis, review accounts that are identified as 'active,'" and "establish the criteria and procedures for conducting the active account review." The WSPs also set forth ways to gather information about a particular active account, including requesting a representative to provide further information on an "[a]ctive [a]ccount [q]uestionnaire," and contacting the customer. As for suitability reviews, the WSPs required the designated supervisor to review customer orders and refer to information contained on new account forms when necessary. The procedures also indicated that a suitability review might require conferring with the registered representative and the compliance department, contacting the customer, and modifying or restricting future transactions.

Ficeto's testimony indicates, however, that he largely failed to implement these relevant WSPs and other tools that would have aided in preventing St. John's unsuitable trading. For example, Ficeto admitted that he never developed any written criteria for selecting accounts to review on a periodic basis, never identified any of St. John's accounts as "active," and never asked St. John to complete an active account questionnaire. Although Ficeto claimed that he told Ludwig that St. John's customers might need to be contacted, Ficeto could not remember if he determined that such a step was required, and did not believe that any letters gauging those customers' "happiness" were ever sent to the customers. Furthermore, Ficeto testified that no restrictions were ever placed on St. John.

C. The Hiring of David Ludwig

On August 7, 2000, Ficeto hired Ludwig to work with the retail department and report directly to Ficeto. Ludwig entered the securities industry in 1990, had worked at several firms including banks, and was qualified to act as a general securities representative. Ludwig had experience selling life insurance, mutual funds, unit investment trusts, and annuities. Ludwig, however, had never sold stocks, had no compliance-related supervisory experience, had not qualified to serve as a general securities principal, and had never conducted suitability reviews of any type, except in connection with his sales of mutual funds. Ludwig's employment agreement indicated that he was hired as a "branch manager," and the record indicates that the Firm

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[9] In his testimony, Ficeto conceded that the trading in JB's and RC's accounts was "possibly" unsuitable for those customers, but he was less willing to concede that the trading in ES's account was unsuitable. In their appeal brief, however, respondents do not contest that St. John effected unsuitable trades for JB, RC and ES.

intended Ludwig to, at some point, take over Abadin's former supervisory role over the retail unit. Ficeto and Ludwig agreed that Ludwig's title would be vice president of sales.

III. Discussion

The Hearing Panel found that, from September 2000 through January 2001, the Firm and Ficeto failed to supervise St. John's unsuitable and excessive trading in three customer accounts, in violation of Conduct Rules 3010 and 2110. We affirm the Hearing Panel's conclusion.

Rule 3010 requires member firms to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [NASD rules.]" Failing to supervise also violates Conduct Rule 2110, which provides that a member, "in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." *See Dep't of Enforcement v. Castle Sec. Corp.*, Complaint No. C3A010036, 2004 NASD Discip. LEXIS 1, at *19-23 (NAC Feb. 19, 2004), *aff'd*, *Michael T. Studer*, Exchange Act Rel. No. 50543 (Oct. 14, 2004). To establish that Ficeto failed to supervise St. John, the Department must demonstrate that Ficeto: (i) had supervisory authority over St. John; and (ii) failed to reasonably exercise such authority. We address each of these elements in turn.

A. VMR Capital Markets and Ficeto Were Responsible for St. John's Supervision

Rule 3010 provides that "[f]inal responsibility for proper supervision shall rest with the member." In addition, the president of a member firm is ultimately responsible for proper supervision of trading activities, unless and until he has reasonably delegated the authority to supervise to another person in the firm, and neither knows nor has reason to know that such person's performance is deficient. *Castle Sec. Corp.*, 2004 NASD Discip. LEXIS 1, at *19-20 & n.13 (citing *William H. Gerhauser*, 53 S.E.C. 933, 940-41 (1998)); *see also Kirk A. Knapp*, 50 S.E.C. 858, 862 (1992). There is no dispute that, at all times relevant to the complaint, Ficeto was president of the Firm and Abadin was no longer the supervisor of the retail unit. Relying principally on Ficeto's testimony, respondents argue that Ficeto was not St. John's direct supervisor because Ficeto reasonably delegated all supervisory responsibilities over the retail unit to Ludwig. Respondents are incorrect, both as a matter of fact and a matter of law.

1. Ficeto Did Not Delegate Supervisory Authority to Ludwig

As a factual matter, the preponderance of the evidence demonstrates that Ficeto did not delegate to Ludwig compliance-related supervisory responsibilities. Of principal significance was Ludwig's testimony. Ludwig understood that his initial role was "sales manager," which involved monitoring attendance, making sure the representatives were working, helping to "grow" the retail group, and educating the retail representatives about mutual funds, asset allocation, financial planning, and annuities. Ludwig did not understand his initial supervisory role, however, to involve compliance-related duties. Ludwig explained that, when he started, he had no discussions with Ficeto about any compliance responsibilities that Ludwig would be assuming and did not believe that his duties required him to be qualified to serve as a general

securities principal. Accordingly, Ludwig did not review either account statements or order tickets.

Ludwig understood that he would act in a supervisory capacity only after he passed the general securities principal qualification examination and after he was trained. Consistent with his understanding, Ludwig immediately scheduled to take, and began studying for, the examination. In October 2000, he attempted to pass the examination, but failed. On January 23, 2001, Ludwig took the examination a second time and passed. In contrast to Ludwig's efforts, however, the Firm made no effort to train Ludwig. Ludwig testified that he did not receive the Firm's compliance manual when he joined (notwithstanding that he acknowledged otherwise in his employment agreement) and that, apart from a few "pointers" on reviewing account activity through his computer, he never received any job-related or supervisory training.

Abadin supported Ludwig's testimony that Ludwig was not trained on how to supervise the registered representatives. Although Ludwig was hired to take over the retail sales manager position that Abadin had relinquished, Abadin testified that he was not asked to provide Ludwig with any training. In fact, Abadin could not articulate whether he had any work-related reasons for speaking with Ludwig.

Carroll Wilson ("Wilson"), a former general securities representative for the Firm, further corroborated Ludwig's testimony that Ludwig did not have a compliance-related supervisory role. According to Wilson, Ficeto never informed him that Ludwig had any compliance responsibilities, adding that "compliance was never really talked about." Instead, Wilson understood that Ludwig was hired to fill Abadin's former role as retail sales manager, which entailed recruiting and managing a sales staff, and ensuring that the brokers were being "productive." Wilson assumed that Ludwig was responsible for reviewing the suitability of trades but testified that Ludwig never reviewed Wilson's trades for suitability, never reviewed his accounts for compliance purposes, never signed off on his correspondence, and never discussed compliance-related issues with him. Wilson, instead, would approach either Abadin or Ficeto for compliance functions, such as obtaining approval of new accounts.

Respondents' witness Dave Banerjee ("Banerjee") also corroborated Ludwig's testimony. At the time of the relevant events, Banerjee was a compliance consultant who, for approximately five years, had served as the Firm's financial and operations principal, maintained the Firm's WSPs, and fielded compliance and audit-related questions. Banerjee testified that Ludwig claimed he had been "hired to help [Abadin] manage the sales force." Slightly contradicting Ludwig's testimony, Banerjee stated that he showed Ludwig how to access the Firm's WSPs on-line and encouraged Ludwig to call with any questions. Nevertheless, Banerjee did not view Ludwig as having compliance responsibilities. According to Banerjee, Abadin asserted that *he* continued to maintain responsibility for the retail sales force, causing Banerjee to believe he "had no reason to communicate with Ludwig." Consequently, Banerjee depended on other principals to perform suitability reviews of order tickets and compliance functions. In fact, Banerjee "would have demanded" that Ludwig first qualify to serve as a general securities principal before signing off on order tickets.

In addition to this testimonial evidence, documentary evidence further demonstrates that Ficeto exercised supervisory responsibility over the retail representatives. Specifically, JB's, RC's and ES's account opening documents were approved by Ficeto, not Ludwig.

Respondents contend, however, that numerous pieces of testimonial and documentary evidence demonstrate that Ludwig did not provide credible testimony about his role at the Firm. In essence, respondents claim that the record shows that Ludwig: (i) understood, or should have understood, that he had supervisory responsibilities over St. John; (ii) was prepared for such supervisory responsibilities, based on his experience and his preparation for the general securities principal examination; (iii) exercised compliance-related supervisory responsibilities; (iv) acknowledged deficiencies in his execution of his supervisory responsibilities; and (v) was biased against Ficeto, who cut Ludwig's pay.

We disagree. Credibility determinations of the initial fact-finder are entitled to considerable weight and deference, and respondents have pointed to nothing that warrants reversing the Hearing Panel's reliance on Ludwig's testimony as credible. *See Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *17-18 (Feb. 10, 2004). Ludwig's understanding that his position did not initially involve compliance-related supervisory responsibilities is reasonable, given the attendant circumstances. At the time he joined the Firm, Ludwig had no experience trading individual equity securities or supervising retail securities activities. Furthermore, Ludwig was not qualified to serve as a general securities principal until late January 2001, after St. John had engaged in nearly all of the trading activities that are at issue. Although Ludwig's employment agreement stated that he was hired as a "branch manager," Ludwig testified that the Firm never made it clear what "branch manager" meant and explained that he did not then appreciate how a "branch manager" at the Firm differed from a branch manager at a bank. Given these circumstances and the absence of a clear assignment of duties, Ludwig's understanding of his role at the Firm is credible.

Respondents also misplace reliance on Ludwig's testimony that he assumed compliance-related supervisory responsibilities. Ludwig credibly testified that he assumed such a role beginning only in late January 2001 or early February 2001, after he passed the general securities principal examination and — more importantly — after the period that is charged in this case. Ludwig further testified that he did not discuss suitability issues with St. John until March 2001, which is corroborated by notes Ludwig took of this discussion. Likewise, respondents read too much into statements in which Ludwig refers to himself as a "supervisor." Ludwig consistently testified that his role when he joined the Firm involved managing the retail sales representatives' productivity, but not their compliance with securities regulations. We see nothing inconsistent between this description and Ludwig's references to himself as a "supervisor."

We also disagree with respondents' argument that order tickets containing the initials "D.L." demonstrate that Ludwig was exercising compliance-related supervisory authority over the retail department. The record is ambiguous concerning whether the initials were Ludwig's or, instead, those of David Liebovitch, who worked for the Firm as an equity trader. In any event, Banerjee and Abadin testified that their initials on order tickets did not reflect that they had reviewed the trades for suitability.

In sum, we find that the preponderance of the evidence demonstrates that neither the Firm nor Ficeto delegated to Ludwig the responsibility to supervise the registered representatives' compliance with their regulatory responsibilities. Ludwig's testimony that he was not delegated such supervisory authority was internally consistent and generally corroborated by several witnesses, including respondents' witness Banerjee. Furthermore, the Hearing Panel correctly concluded that there is no reliable testimonial or documentary evidence supporting Ficeto's claim that he did delegate supervisory responsibilities.

2. A Delegation of Supervisory Authority to Ludwig Would Have Been Unreasonable

Even if Ficeto had delegated authority to Ludwig to supervise the Firm's retail unit — which Ficeto did not — such delegation would have been unreasonable as a matter of law. Ludwig had never sold stocks; had no compliance-related supervisory experience; had never conducted any suitability reviews of any type, except in connection with his sales of mutual funds; and the Firm provided him with no training to make up for his lack of relevant experience. Moreover, persons who have the responsibility for supervising the activities of persons associated with a member at an Office of Supervisory Jurisdiction are required to be registered as principals. *See* Membership and Registration Rule 1021(a) and (b); Conduct Rule 3010(a)(4) and (g)(1)(G). Ludwig did not take the examination to serve as a general securities principal until October 2000, and did not pass it until late January 2001. In light of Ludwig's lack of relevant experience and appropriate qualification, and the absence of any appropriate training by the Firm, any delegation of supervisory authority to him would have been unreasonable. That Ludwig was studying for the general securities principal examination during this time does not change our conclusion.

Respondents erroneously contend that, despite Ludwig's failure to pass the appropriate qualification examination within 90 days after filing his registration application, former Rule 1021(d)(3) permitted him to continue to serve as a principal for an additional 90 days because he rescheduled to take the examination. That Ludwig was scheduled to take the qualifying examination is not *prima facie* evidence that a delegation of supervisory authority to him would have been acceptable. Given Ludwig's lack of relevant experience and training, delegating supervisory authority to him would have been unreasonable. Furthermore, former Rule 1021(d) permitted an appropriately competent person to serve as a principal no later than 90 days after filing a registration application without passing the qualification examination.[10] Respondents'

[10] Rule 1021(d)(2) provides that "[a]ny person not presently associated with a member as a Registered Representative seeking registration as a Principal" shall "be allowed a period of ninety days [after submitting a registration application and required fees] to pass the appropriate Qualification Examination for Principals." Former Rule 1021(d)(3) provided that, "[i]f an applicant [for principal] does not take the examination within the ninety calendar day period or if the applicant fails the examination, a new principal elevation form and examination fee shall be required." On February 26, 2003, subsection (d)(3) of Rule 1021 was deleted. *See Notice to Members 03-20*, 2003 NASD LEXIS 22, at *2 (Apr. 11, 2003).

differing interpretation of former Rule 1021 would have allowed a person who repeatedly failed the appropriate qualifying examination to nevertheless serve as a principal for months, provided that he simply scheduled to take additional examinations. Such an interpretation would have rendered NASD's examination program all but meaningless. *See Notice to Members 03-20*, 2003 NASD LEXIS 22, at *2 (describing respondents' interpretation of former Rule 1021 as "inaccurate[ ]" and explaining clarifications to the rule).

Accordingly, we conclude that VMR Capital Markets and Ficeto are the responsible parties for any failures to supervise St. John from September 2000 through January 2001. We now turn to whether Ficeto and VMR Capital Markets failed to reasonably supervise St. John.

B. VMR and Ficeto Failed to Reasonably Supervise St. John

A supervisor is responsible for "reasonable supervision," a standard that "is determined based on the particular circumstances of each case." *Christopher J. Benz*, 52 S.E.C. 1280, 1284 (1997), *petition for review denied*, 168 F.3d 478 (3d Cir. 1998) (table). The SEC has held that "[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review." *Id.* at 1283 n.13 (quoting *Edwin Kantor*, 51 S.E.C. 440, 447 (1993)); *see also Houston A. Goddard*, 51 S.E.C. 668, 672-73 (1993).[11]

St. John's trading activities generated numerous "red flags" that his trades were not suitable for JB, RC and ES.[12] According to their account opening documents, JB, RC and ES had relatively conservative investor profiles. Nevertheless, St. John made numerous trades in each of these accounts, including in-and-out trading of individual securities, and trades of highly speculative securities such as Stan Lee Media. Such trades were qualitatively unsuitable trades for his customers. *Howard*, 2000 NASD Discip. LEXIS 16, at *15-24 (finding that recommendations of speculative securities were qualitatively unsuitable). In addition, there were numerous red flags that St. John was excessively trading the accounts of his customers. *John M. Reynolds*, 50 S.E.C. 805, 806 (1991) ("Excessive trading may be thought of as quantitative unsuitability."). As an NASD staff analysis demonstrates, the annual turnover ratios in JB's,

[11] The burden is on the Department to show that respondents' conduct was not reasonable. *Dist. Bus. Conduct Comm. v. Lobb*, Complaint No. C07960105, 2000 NASD Discip. LEXIS 11, *16 (NAC Apr. 6, 2000).

[12] NASD's suitability rule provides that, "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Conduct Rule 2310; *see also Dane S. Faber*, 2004 SEC LEXIS 277, at *23-24 (holding that a broker's recommendations "must be consistent with his customer's best interests, and he or she must abstain from making recommendations that are inconsistent with the customer's financial situation").

RC's and ES's accounts were between 38.88 and 59.46, which were extremely high and indicative of irregularities. *Howard*, 2000 NASD Discip. LEXIS 16, at *21 ("[T]he courts and the SEC have held that there is little question about the excessiveness of trading when an annual turnover rate in an account is greater than six."). The high level of St. John's commissions — "commission-to-equity" ratios for JB's, ES's and RC's accounts were between 47% and 64% — also exhibited signs of excessive trading. *Id.* at *22-23 & n.23 (explaining that excessive trading has been found where the "cost-equity ratio was between 15 and 30 percent, or more"). Ficeto should have treated these warning signs with a heightened sense of alarm, given that St. John's background was in mutual funds.

Ficeto testified that he was aware as early as November 2000 that St. John's accounts presented suitability issues. Despite his awareness of such irregularities, however, Ficeto largely failed to implement the relevant WSPs and other tools that would have aided in preventing St. John's unsuitable trading. Respondents argue, however, that Ficeto testified that he took several steps to review St. John's trading, including monitoring St. John's conversations with customers, prodding Ludwig to talk with St. John, and questioning St. John directly. Ficeto explained that he detected "nothing . . . out of the ordinary" and accepted St. John's assurances that he had known these customers for a long time, met with them regularly, and made trades that were consistent with their objectives.[13]

The preponderance of the evidence, however, demonstrates that Ficeto failed to take steps to supervise St. John. According to Ludwig, Ficeto never expressed to Ludwig any dissatisfaction with St. John, but instead praised St. John's productivity in front of the other retail representatives. Ludwig also denied that Ficeto had ever asked Ludwig to discuss with St. John the trading in JB's, RC's or ES's accounts. Instead, Ludwig testified that the first time he discussed with St. John his trading activities was not until March 2001, after St. John confessed to Ludwig that "there may be some issues" regarding RC's account. After having that discussion with St. John, Ludwig informed Ficeto of St. John's concerns.

Wilson corroborated Ludwig's testimony that Ficeto praised St. John's trading activities. Wilson also described the Firm's supervisory system as having serious flaws. Wilson testified that he was given a copy of the Firm's compliance manual for registered representatives, and that Abadin and David Terrell, a representative and Wilson's first supervisor, were available to provide advice concerning compliance issues. Apart from that, however, Wilson had nothing positive to say about the Firm's compliance system. Wilson was not provided with a copy of the WSPs, mistakenly thought that Banerjee was the Firm's compliance officer, and was unsure who his supervisor was after Abadin made a transition to institutional sales. When asked who reviewed his trades for suitability, Wilson said, "I don't want to say non existent [sic], but it really was. I don't really remember any suitability issues . . . ." Wilson explained that the

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[13] When asked how he verified that Ludwig monitored St. John, Ficeto claimed he observed Ludwig reviewing St. John's accounts and talking with St. John, and received a verbal report from Ludwig.

persons who signed off on order tickets did "not necessarily" review those tickets for compliance purposes. Furthermore, Wilson had never seen an active account report at the Firm, and was never asked to complete an active account questionnaire for accounts that did not involve options trading. Wilson also stated that, during his time with the Firm, only one compliance meeting was held, and no one reviewed his correspondence. In short, Wilson stated that "compliance was never really talked about." Wilson's assessment of the Firm's compliance program did not change after Ludwig joined.

Abadin's testimony also indicated that no one at the Firm was conducting suitability reviews of trades: Abadin did not know who reviewed his or other order tickets for suitability. And despite previously serving as the retail sales supervisor, Abadin did not know whether any Firm procedure governed how to indicate a suitability review of an order ticket. Even respondents' witnesses testified that the Firm was not complying with its WSPs. Banerjee admitted that some order tickets in the record did not contain initials indicating that the order had been reviewed for suitability, even though the Firm's WSPs required it. In addition, respondents' expert witness David Semak testified that he found no evidence that the WSPs were carried out.

Given this record, Ficeto's assertion that he took any steps to monitor St. John is not credible. But even if Ficeto credibly testified about his efforts to supervise St. John — which he did not — his acceptance of St. John's representations would have been insufficient supervision. Where a supervisor discovers red flags indicating trading irregularities, the supervisor cannot "discharge his or her supervisory obligations simply by relying on the unverified representations of employees." *Michael H. Hume*, 52 S.E.C. 243, 248 (1995) (involving excessive trading). Instead, a supervisor faced with red flags has a "duty to follow-up and investigate." *Dist. Bus. Conduct Comm. v. Merten*, Complaint No. C8A950030, 1997 NASD Discip. LEXIS 71, at *19-20 (NBCC Oct. 31, 1997) (holding president failed to supervise registered representative where president discussed a suitability issue only with the representative involved); *Bradford John Titus*, 52 S.E.C. 1154, 1161 n.24 (1996); *Albert Vincent O'Neal*, 51 S.E.C. 1128, 1132, 1134 (1994). The duty to follow up and investigate should have been especially obvious to Ficeto, who admitted that he did not expect St. John to be "open and a hundred percent honest with me."

For these reasons, we conclude that VMR Capital Markets and Ficeto failed to reasonably supervise St. John, in violation of Rules 3010 and 2110. We now turn to an assessment of appropriate sanctions.

IV. Sanctions

The Hearing Panel fined VMR Capital Markets and Ficeto $25,000, jointly and severally, and suspended Ficeto in all supervisory capacities for 15 business days. The Hearing Panel also ordered respondents to pay, jointly and severally, costs of $2,748.69. We affirm the suspension and the costs, but we modify the fine imposed.

For failing to supervise, the NASD Sanction Guidelines ("Guidelines") (2001 ed.) recommend a fine ranging from $5,000 to $50,000, and suggest that the adjudicator consider independent (rather than joint and several) monetary sanctions for the firm and the responsible individual. Adjudicators may increase the recommended fine amount by adding the amount of a

respondent's financial benefit. As for suspensions, the Guidelines suggest that the adjudicator consider suspending the responsible individual in all supervisory capacities for up to 30 business days, and consider limiting the activities of the appropriate department for up to 30 business days.[14]

In deciding upon an appropriate sanction, we have considered both the Guidelines' principal considerations and the considerations that are specific to failing to supervise. In this case, such considerations demonstrate that respondents' violation, while not egregious, was serious. The nature and extent of the violation is troubling. Although St. John was purportedly one of the Firm's only productive representatives, respondents failed to supervise St. John over a period of several months. In addition, respondents' violation indirectly resulted in three customers incurring substantial losses, totaling $63,070 by January 2001. Furthermore, respondents' violation resulted in the potential for their monetary gain: the Firm retained between 30% to 50% of St. John's commissions, earning approximately $19,000 on St. John's trades in JB's, RC's and ES's accounts.

We also find that Ficeto's failure to supervise was reckless. Due to the numerous and conspicuous red flags, Ficeto was acutely — and admittedly — aware of the suitability issues raised by St. John's trading activities. And as president, compliance officer, registered principal, and the person responsible for ensuring that the Firm's WSPs were implemented, Ficeto knew or should have understood that his supervisory duties required more than making limited inquiries with St. John.

We do not find any mitigating factors. There is no evidence that respondents voluntarily and reasonably attempted to pay restitution or otherwise remedy the misconduct. In addition, the Firm did not properly implement relevant WSPs, either generally or specifically, with respect to St. John.

We do not agree with the Hearing Panel that respondents' closing of its retail department in late 2001 is mitigating. Although the Hearing Panel found that the Firm closed its retail department in response to St. John's conduct, the record does not clearly show what respondents' motivation was. After being questioned about St. John's trading, Ficeto said in his investigative testimony, "[St. John] and the other brokers are the reasons we are not engaged in retail business anymore." In their pre-hearing brief, however, respondents asserted that closing the retail unit was prompted by "market conditions," "changes in the industry," a desire to focus on institutional customers, and difficulties finding qualified managers. While efforts to employ subsequent corrective measures can be mitigating where they are undertaken to avoid recurrence of misconduct and before detection by a regulator, we cannot conclude that respondents have made any such showing.

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[14] Sanction Guidelines (2001 ed.) at 108 (Supervision – Failure to Supervise). The Guidelines contain additional suggestions for "egregious" cases of failing to supervise, which are not pertinent here.

The Hearing Panel also gave Ficeto credit for cooperating with NASD during its investigation. The provision of "substantial" assistance to NASD in connection with its examination or investigation of misconduct can be mitigating. Guidelines (2001 ed.) at 10 (Principal Consideration No. 12). Based on our review of the record, however, we find that Ficeto's cooperation with NASD only met his requirements.

Respondents contend that a mitigating factor is that St. John lied about his trading activities. We disagree. Where the individuals responsible for the underlying misconduct attempt to conceal it, such a circumstance can mitigate a supervisor's failure to supervise. But where, as in this case, an attempted concealment does not prevent the detection of the underlying misconduct, it does nothing to lessen the seriousness of a supervisory failure. Respondents also contend that Ficeto's reliance on legal advice that he could delegate supervisory authority to Ludwig is mitigating. Respondents' argument is inapposite, in light of our finding that Ficeto did not delegate supervisory responsibility to Ludwig. In any event, Ficeto's self-serving assertion that he relied on counsel was uncorroborated and lacking in specifics such as the name of the lawyer with whom he allegedly conferred.

Based on our overall consideration of the record, including the respondents' financial benefit, we affirm the suspension imposed by the Hearing Panel, but we increase the fine imposed on respondents to $40,000. Respondents are jointly and severally liable for the fine. Such sanctions are appropriate to deter and remedy the misconduct.

V. Conclusion

Accordingly, we affirm the Hearing Panel's decision that VMR Capital Markets and Ficeto failed to supervise St. John, in violation of Rules 3010 and 2110. We impose on the Firm and Ficeto, jointly and severally, a fine of $40,000, and we suspend Ficeto in all supervisory capacities for 15 business days.[15] We also order the Firm and Ficeto to pay, jointly and severally, hearing costs of $2,548.49 and appeal costs of $2,559.96.

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President
And Corporate Secretary

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[15] We also have considered and reject without discussion all of respondents' other arguments.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any 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.