BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. Respondent Respondent.	DECISION Complaint No. C9B040020 Dated: August 8, 2006

Department of Enforcement did not carry its burden of proving by a preponderance of the evidence that respondent failed to take appropriate supervisory action. Held, findings affirmed.

Appearances

For the Complainant: Counsel 1, Counsel 2

For the Respondent: Respondent's Attorney 1, Respondent's Attorney 2

Decision

Pursuant to NASD Procedural Rule 9311, NASD's Department of Enforcement ("Enforcement") appeals a decision by a Hearing Panel, finding that Enforcement did not establish by a preponderance of the evidence that Respondent violated NASD Conduct Rules 3010 and 2110.[1] Respondent's alleged violations stem from Enforcement's claim that he failed

[1] NASD Conduct Rule 2110 requires that NASD members shall, in conducting their business, "observe high standards of commercial honor and just and equitable principles of trade." The Commission has previously determined that a violation of NASD Conduct Rule 3010 can also be a violation of NASD Conduct Rule 2110. *See Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *2 n.3 (July 6, 2005) (*citing Stephen J. Gluckman*, 54 S.E.C. 175, 185 & n.31 (1999)). In addition, NASD Conduct Rule 115 makes all NASD rules, including NASD Conduct Rule 2110, applicable to both NASD members and all persons associated with NASD members.

to supervise reasonably a registered representative, Employee 1, who engaged in a pattern of unsuitable mutual fund switches in a customer's accounts. After a thorough review of the record, we affirm the Hearing Panel's decision.

I. Background

Respondent entered the securities industry as a trainee in 1978. Respondent became registered as a general securities representative in September 1979. In February 1984, he also became registered as a general securities sales supervisor. Respondent is currently a manager in the branch office of Firm A. Respondent has been a branch manager for Firm A since 1986. At the time of the events at issue, the office employed more than 20 registered representatives who handled approximately 10,000 accounts. In addition, the office had as much as $1 billion in assets under management, executed tens of thousands of trades per year, and grossed about $10 million in commissions between 2001 and 2002.

II. Procedural History

Enforcement filed a complaint against Employee 1 and Respondent. The complaint alleged that Employee 1 had engaged in excessive trading of mutual funds in two accounts of a single customer and that Respondent failed to supervise reasonably Employee 1's trading in these accounts.[2] In response, Respondent filed an answer in which he contested the charge and requested a hearing. A Hearing Panel conducted hearings. The parties filed post-hearing briefs. In a decision the Hearing Panel found that Enforcement did not meet its burden of proof regarding Respondent's alleged supervisory violations. Enforcement's appeal followed.

III. Facts

This case arises out of trading in the accounts of an 88 year-old retiree, JL, who opened an individual account with Employee 1 in 1998. Employee 1 was employed as a registered representative at Firm A from August 1997 until August 2003. Respondent was Employee 1's supervisor during this period. Until the events at issue in this matter, Employee 1 had never been the subject of a customer complaint. JL's new account form for his individual account listed his investment objectives as "Tax-Free—Income Conservative." Between 1998 and January 2001, JL held only low-risk bonds and CDs in this account. In January 2001, however, JL opened a second account with Employee 1 with an initial investment of $200,000. The second account was a trust account. The primary investment objective for this trust account was identified on the new account form as "Growth-Aggressive." Also in January 2001, Employee 1 filled out an updated new account form for JL's individual account, changing the investment objectives from "Tax-Free Income—Conservative" to "Growth" and "Speculation."[3]

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[2] Employee 1 settled the charges against him, agreeing to a six-month suspension and payment of $22,500 in restitution to the customer.

[3] JL never signed this updated new account form, and there is no evidence that it was ever sent to him. In addition, the investment objectives listed on JL's monthly statements for this account did not reflect a change from JL's original investment objective.

Under Respondent's supervision, from January 2001 through June 2001, and again from February 2002 through August 2002, Employee 1 engaged in a total of more than 60 transactions involving the purchase or sale of mutual funds in both of JL's accounts. These transactions primarily involved mutual fund switches between open-end and closed-end mutual funds.[4] However, both legs of these mutual fund switches were rarely completed on the same day. Instead, they occurred with the passage of weeks or months between the sale and the subsequent purchase.

Firm A maintained a supervisory system that automatically generated a warning letter when a mutual fund switch occurred. This system, however, could not detect mutual fund switches if they occurred between an open-end and closed-end fund. The system was also not designed to detect certain switches unless the sale and purchase occurred on the same day. Consequently, the mutual fund switches executed by Employee 1 were not flagged by Firm A's warning system.

Similarly, Firm A maintained a supervisory system that automatically generated a notice whenever a transaction came within 5 percent of being eligible for a breakpoint.[5] None of the transactions executed by Employee 1 in JL's accounts generated a notice indicating that JL could have taken advantage of a breakpoint discount. On at least one occasion, however, Respondent independently instructed Employee 1 to restructure JL's purchases to make JL eligible for a breakpoint discount.[6]

As a branch manager, Respondent reviewed the blotter that detailed all of the transactions in JL's accounts. As part of this review, Respondent identified several trades in JL's individual account that were inconsistent with JL's primary investment objective of "Tax-Free Income—Conservative." In particular, Respondent noticed that, from May 7 to May 10, 2001, Employee 1 had sold $112,000 of Fund 1 held in JL's individual account. Respondent asked Employee 1 the reason for this sale, and Employee 1 told him that it was because JL wanted to purchase a fund

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[4] Mutual fund switching, as defined by the Commission, involves "liquidating holdings of [mutual fund] shares and using the proceeds to purchase shares of various other [mutual funds]." *Norwest Inv. Servs., Inc.*, Exchange Act. Rel. No. 45460, 2002 SEC LEXIS 397, at *3 (Feb. 20, 2002) (citation omitted). Mutual fund switching "violates the antifraud provisions of the federal securities laws when a registered representative, in order to increase his compensation, induces investors to incur the costs associated with redeeming shares of one mutual fund and purchasing shares of another and the benefit to the customer does not justify the costs." *Id.* at *3-4 (citation omitted). An open-end fund is a fund that issues new shares when investors put in money and redeems shares when investors withdraw money. In contrast, a closed-end fund has a fixed number of shares that trade over-the-counter or on a stock exchange.

[5] A "breakpoint" is a volume discount on sales charges received in connection with the purchase of a mutual fund.

[6] Respondent was mistaken about the availability of the breakpoint discount for the particular purchase, and JL ultimately did not receive the discount.

that paid a dividend. Respondent was aware, however, that Fund 1 paid a monthly dividend. Respondent sought more information from Employee 1 about this transaction, and Employee 1 told Respondent that JL did not sell all of his Fund 1 holdings, but had liquidated some of them to pay a $100,000 tax bill.[7] Upon receiving this response, Respondent did not question Employee 1 further regarding his trading in JL's accounts.

Respondent also reviewed, on a quarterly basis, a three-month commission report ("Quarterly Commission Report") and an account profile for JL's accounts. These materials contained detailed information, including: (1) the commissions generated in the accounts for the prior quarter by security type, (2) a list of all the trades in the accounts for the current quarter, and (3) the gains and losses in the accounts.

Respondent's June 15, 2001, review of the Quarterly Commission Report and JL's account profile informed him that both of JL's accounts had suffered losses[8] while the accounts had generated more than $12,000 in commissions.[9] After reviewing this information, Respondent invited JL to meet with him to discuss his accounts. A meeting between Respondent and JL took place on June 25, 2001.

At the meeting, Respondent observed that JL was elderly and had impaired hearing. JL told Respondent that he was unhappy with the performance of his accounts and the commissions that he was being charged. At no time during this meeting did JL inform Respondent that Employee 1 had made unauthorized trades. Instead, JL told Respondent that he was happy with Employee 1, but that he could not afford additional losses in his accounts.[10] After meeting with JL, Respondent told Employee 1 that he should stop recommending so many trades in JL's accounts and that Employee 1 should keep JL in his existing investments.

By letter dated July 25, 2001, JL sent Firm A's chairman a formal complaint regarding the losses in his accounts. In this letter, JL stated for the first time that the trading in the accounts was unauthorized and excessive. Shortly thereafter, Firm A's legal department initiated an investigation of JL's complaint. At this point, Respondent instructed Employee 1 to cease all trading in JL's accounts and to refrain from contacting JL regarding the complaint. Days later, however, Employee 1 provided Respondent with a letter dated August 16, 2001, signed by JL and printed on Firm A's letterhead. This letter purported to rescind JL's formal complaint, and it

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[7] Employee 1 had previously told Respondent that JL had made a real estate sale for approximately $800,000. JL also testified that he had a large capital gains tax as a result of a real estate sale and that he had discussed it with Employee 1.

[8] After Respondent's review, he discovered that JL had lost $39,000 and $10,000 in his individual and trust accounts, respectively, as of June 15, 2001.

[9] The Quarterly Commission Report revealed that Employee 1 had made approximately $12,000 in commissions over the period covered by the report.

[10] JL testified, however, that because of his impaired hearing, he had difficultly communicating with Respondent and was frustrated by the June 2001 meeting.

stated that there had been no unauthorized trading in the accounts. Employee 1's use of Firm A's letterhead for this purpose was a violation of Firm A's internal policies. Respondent immediately forwarded the letter to Firm A's legal department. After discussing the matter with his regional manager, Respondent decided that he would not discipline Employee 1 while the legal department was conducting its investigation.

In February 2002, Respondent authorized Employee 1 to resume trading in JL's accounts so that he could purchase bond funds. These bond funds charged a commission but were recommended by Firm A because they were trading at a discount.[11] Respondent required JL to sign a Long Term Product Disclosure Statement prior to Employee 1 purchasing the bond funds.[12] Respondent also authorized Employee 1 to purchase tax-free, no load municipal funds for JL. Respondent required JL to submit a letter acknowledging that Employee 1's purchase of the municipal funds was authorized. Respondent testified that each of these funds had equal or higher yields than the funds that JL held prior to replacing them. Firm A ultimately settled JL's complaint for $35,000 in October 2002. In March 2003, Firm A ended its business relationship with JL. Firm A also terminated Employee 1 in August 2003.

IV. Discussion

After reviewing the facts set forth in the record, we affirm the Hearing Panel's finding that Enforcement failed to prove by a preponderance of the evidence that Respondent did not exercise reasonable supervision.

A. Respondent Had a Duty to Respond to Potential Red Flags

NASD Procedural Rule 3010(a) requires that firms maintain a supervisory system "reasonably designed to achieve compliance with" securities laws and regulations and with NASD rules. *Castle Sec. Corp.,* Exchange Act Rel. No. 52580, 2005 SEC LEXIS 2628, at *7 (Oct. 11, 2005). Under this system, supervisors have a duty, among other things, "to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation." *Michael T. Studer*, Exchange Act Rel. No. 50543A, 2004 SEC LEXIS 2828, at *23 (Nov. 30, 2004) (citation omitted); *accord George J. Kolar*, Exchange Act Rel. 46127, 2002 SEC LEXIS 1647, at *11 (June 26, 2002) (stating that "[d]ecisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations."); *Quest Capital Strategies, Inc.*, Exchange Act Rel. No. 44935, 2001 SEC LEXIS 2147, at *13-14 (Oct. 15, 2001) (stating that "supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention") (citation omitted); *Consolidated Inv. Servs., Inc.*, 52 S.E.C. 582, 588 (1996) (stating that "any indication of irregularity brought to a supervisor's attention must be treated

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[11] Respondent testified that these funds were trading at discounts ranging from 25 to 30 percent.

[12] In both April and August 2002, Respondent authorized Employee 1 to purchase other securities for JL. Respondent required JL to sign a letter authorizing these transactions and confirming that he understood that commissions would be charged.

with the utmost vigilance") (citations omitted). Consequently, a supervisor's failure to respond to such red flags constitutes a failure to supervise reasonably under NASD rules. *See Studer*, 2004 SEC LEXIS 2828, at *26 (citation omitted).

Here, Enforcement identified five "red flags" that Respondent allegedly ignored while supervising Employee 1. The Hearing Panel, however, found that Respondent responded reasonably to these red flags. We agree and discuss Respondent's reaction to each of these red flags in turn.

B. Respondent's Response to Potential Red Flags Was Reasonable

1. *Employee 1's improper trading of mutual funds in JL's accounts*

Unlike in prior cases where we have found liability for a failure to supervise, the facts of this case show that when Respondent was made aware of Employee 1's questionable conduct, he took action to investigate and prevent securities violations. *But cf. Quest Capital Strategies, Inc.,* 2001 SEC LEXIS 2147, at *15-16 (finding supervisory liability where supervisor failed to respond to clear indication that employee was still conducting a prohibited loan program).

Enforcement argues that Respondent initially ignored the improper mutual fund switching in JL's accounts. Respondent, however, was not aware of the improper "switching" transactions that Employee 1 executed in JL's accounts until months after they had occurred. This is because by spacing the purchase and sale of the funds over a period of weeks or months, Employee 1 executed the transactions in a manner that avoided detection by Respondent's daily review of the blotter. Moreover, Employee 1 structured the transactions to involve transfers between open-end and closed-end mutual funds—transfers that would not trigger the automatic alerts generated under Firm A's supervisory system to detect mutual fund switching.[13]

Respondent's first indication that Employee 1's trading in JL's accounts was problematic followed his June 2001 review of the Quarterly Commission Report and JL's account profile. Upon finding that JL's accounts had suffered almost $50,000 in losses while generating $12,000 in commissions for Employee 1, Respondent did not ignore the potential problem. Instead, he investigated the matter by meeting directly with JL to discuss the accounts. We therefore find that Respondent acted reasonably once he discovered the potential irregularities regarding the losses and commissions in JL's accounts, and that Enforcement failed to prove that Respondent failed to exercise reasonable supervision by failing to detect the irregularities sooner. *Compare Randolph K. Pace*, 51 S.E.C. 361, 370 (1993) (finding supervisory liability where manager did not make a "diligent inquiry" into trading activity after indications of irregularity were brought to his attention).

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[13] The complaint does not allege that Respondent was responsible for designing Firm A's automatic alert system nor does it allege that Respondent should have been aware that the system was so ineffective that he should not have relied on it as one aspect of performing his supervisory responsibilities.

Additionally, Enforcement argues that Respondent's failure to force Employee 1 to obtain breakpoints in executing some of JL's mutual fund transactions is evidence of inadequate supervision. During the relevant time period, however, there were thousands of mutual funds offered through Firm A with various triggers for breakpoints. Respondent's review of Employee 1's trades, therefore, would not have allowed Respondent to know when JL was eligible for a breakpoint unless Respondent had memorized each of these individual breakpoint triggers. Firm A maintained a supervisory system designed to identify these triggers and issue a warning when a transaction came within 5 percent of being eligible for a breakpoint. As noted above, none of the transactions at issue here generated such a warning, and there is no evidence in the record that Respondent had any reason to believe that this system was inadequate. Moreover, the record shows that Respondent made at least one independent effort to secure breakpoint discounts for JL. Under these facts and circumstances, we find that Respondent's execution of his supervisory duties regarding JL's breakpoint eligibility was reasonable.

2. *Employee 1's inconsistent explanations*

Where a supervisor is aware of a clear indication or risk of misconduct by an employee, the supervisor must take action to prevent possible violations of the securities laws. *See Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558 at *42 & n.44 (July 6, 2005) (emphasizing the need for supervisors to adopt heightened supervisory measures when their firms employ persons who have known regulatory problems or customer complaints) (citations omitted); *Consolidated Inv. Serv.*, 52 S.E.C. at 588-89 (stating that "[a] registered representative who has previously evidenced misconduct can be retained only if he subsequently is subjected to a commensurately higher level of supervision"). Enforcement argues that Employee 1's inconsistent explanation for the irregular trading in JL's accounts was a clear indication of misconduct. Enforcement further argues that Respondent's supervision of Employee 1 was inadequate because he did not question Employee 1's inconsistent explanations for the trading in JL's accounts. The record, however, does not support Enforcement's arguments.

On May 7, 2001, Respondent's review of daily trading records caused him to question Employee 1 about the sale of Fund 1 because it appeared to be inconsistent with JL's stated investment objective of "Tax-Free Income—Conservative." Enforcement argues that Respondent recklessly ignored that: (1) Employee 1's initial explanation for the trade was irrational, and (2) Employee 1 provided an entirely different explanation when confronted by Respondent. The record shows, however, that Respondent did not accept Employee 1's initial explanation. Instead, Respondent pressed Employee 1 until Employee 1 provided a reasonable explanation, and Respondent had a reasonable basis for not being suspicious of Employee 1's initial response.

Employee 1 first told Respondent that the Fund 1 sale was made so that JL could move out of a conservative stock and into a fixed income security that would offer a dividend. Respondent, however, knew that the Fund 1 paid a monthly dividend and that Employee 1's explanation did not make sense. Respondent testified that, based on his many years of experience, he took Employee 1's initial explanation as an example of a "flip" off-hand answer that brokers often offered not to cover up misconduct, but to satisfy a supervisor without giving a

more thorough or careful explanation.[14] Consequently, Respondent pushed Employee 1 to clarify the purpose for the Fund 1 sales.

Employee 1 then told Respondent that JL had incurred a large tax bill from a real estate sale and that he sold the Fund 1 to pay for this bill. From previous conversations that Respondent had with Employee 1, he was aware that JL had sold a piece of real estate for approximately $800,000.[15] At this point, Respresentative A's improper mutual fund switching had not been detected because the Quarterly Commission Report was not yet available for Respondent's review. In addition, Employee 1 had never had a problem before and had received no customer complaints. Respondent therefore had not received any clear indication of misconduct by Employee 1. Consequently, we find that it was reasonable for Respondent to accept Employee 1's rationale for making the trades without further investigation.[16]

3. JL's complaints at the June 2001 meeting and on July 25, 2001

Enforcement claims that Respondent did not respond reasonably to JL's complaints voiced at a June 2001 meeting with JL. At this meeting, JL told Respondent that he could not afford additional losses in his accounts. JL also expressed a concern about the commissions that the accounts were generating.

Following Respondent's meeting with JL, he instructed Employee 1 to maintain JL's positions to avoid future losses from commission charges. In other words, Respondent placed a

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[14] After seeing and hearing Respondent, the Hearing Panel concluded that Respondent was a "knowledgeable, careful, and responsible professional." The industry members of the Hearing Panel credited Respondent's interpretation of Employee 1's response as consistent with their supervisory experience. Consequently, the Hearing Panel did not find that Employee 1's statement was an indication of an improper motive rising to the level of a red flag. We see no reason to overturn the Hearing Panel's finding, which turned appropriately in large part on its evaluation of Respondent's credibility and demeanor. *See Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *17-18 (Feb. 10, 2004).

[15] At the June 2001 meeting, JL informed Respondent that he had sold some property. Respondent and JL, however, did not have any specific discussion about the tax bill associated with this sale.

[16] It is certainly true that, in hindsight, Respondent could have done more to investigate Employee 1's erratic responses, but we find that Enforcement did not meet its burden of showing that Respondent's actions were unreasonable under the circumstances. *See Dist. Bus. Conduct Comm. v. Lobb*, Complaint No. C07960105, 2000 NASD Discip. LEXIS 11, at *16-17 (NAC Apr. 6, 2000) (stating that Enforcement does not meet its burden in failure to supervise cases by showing that a supervisor's actions were not "perfect" or "could have been better" under the circumstances); *Patricia Ann Bellows*, Initial Decisions Rel. No. 128, 1998 SEC LEXIS 1521, at *24-25 (July 23, 1998) (finding no supervisory liability even though a more thorough investigation by broker's supervisor would have revealed broker's misconduct) (citation omitted).

limit on Employee 1's trading activities in JL's accounts after investigating and discovering a potential problem regarding disproportionate commissions and losses—which was a reasonable response under the facts of this case. *See Edwin Kantor*, 51 S.E.C. 440, 446 (1993) (stating that "[w]here a supervisor is aware of misconduct by an employee, the supervisor must 'take action to discipline . . . or to limit [the] activities' of that employee") (*quoting John H. Gutfreund*, 51 S.E.C. 93, (1992)). *But cf. Randolph K. Pace*, 51 S.E.C. 361, 370 (1993) (finding supervisory liability where supervisor who discovered evidence that stock had been manipulated did not immediately halt his firm's trading of stock at artificially high prices).

Respondent's decision to limit Employee 1's trading activity is even more reasonable given that Respondent did not receive any obvious indication from his meeting with JL that Employee 1 had handled JL's accounts improperly. At no point during this meeting, for example, did JL complain about Employee 1 or suggest that the trading in his accounts was unauthorized. In fact, Respondent testified that JL informed him that he liked Employee 1. In addition, Respondent testified that JL said that he was satisfied and did not appear frustrated in any way. During JL's own testimony, he acknowledged that he did not inform Respondent about his frustration at the June 2001 meeting. Consequently, we reject Enforcement's argument that Respondent failed to respond reasonably to JL's concerns.

Similarly, we find that Respondent's response to JL's July 2001 letter was reasonable under the circumstances. Enforcement argues that JL's July 2001 letter was yet another "red flag" that should have prompted Respondent to take further supervisory action against Employee 1. The Commission, however, has stated that "[s]upervision is reasonable only if there is adherence to appropriate internal company procedures." *Consolidated Inv. Servs., Inc.*, 52 S.E.C. at 586 (citation omitted). In this case, Respondent followed Firm A's internal policy of adopting a "hands off" approach until the legal department's investigation was complete. Both Respondent and Firm A's regional manager confirmed that once the investigation began, it was Firm A's policy for Respondent to refrain from taking any disciplinary action against brokers under investigation or conducting any independent investigation without the legal department's consent. An Enforcement witness confirmed that this was a common practice throughout the industry.

Respondent received no guidance from Firm A's legal department as to whether or not to take any disciplinary action against Employee 1. Under these circumstances, Respondent took the only action he felt he was authorized to take—which was to instruct Employee 1 to cease all trading in the accounts and to refrain from contacting JL regarding the complaint. Consequently, we are not persuaded that Respondent's failure to discipline Employee 1's upon his own initiative was unreasonable.+

4. Employee 1's use of letterhead

Enforcement argues that Respondent's failure to take stronger action against Employee 1 for his improper use of Firm A's letterhead was a breach of Respondent's supervisory duties. The Hearing Panel did not find that Respondent's overall supervision was unreasonable even though Respondent could have imposed a harsher penalty for Employee 1's conduct. We agree. After discovering that Employee 1 had violated Firm A's policy on the use of letterhead,

Respondent was obligated to take reasonable action to prevent further misconduct. Respondent, however, knew that Firm A's investigation of Employee 1 was ongoing and that the legal department was still determining how Firm A would react to JL's letter. Respondent was also aware that Firm A's policy regarding the use of letterhead was intended primarily to control outgoing letters that would potentially bind Firm A. Balancing these factors, Respondent decided to place Employee 1 under closer supervision rather than impose a more severe sanction. In addition, Respondent consulted with his regional manager who supported Respondent's decision not to discipline Employee 1. Under these circumstances, we do not find that Respondent's supervisory response to Employee 1's improper use of Firm A's letterhead was unreasonable.

5. *Employee 1's further trading in JL's accounts*

Finally, Enforcement claims that Respondent unreasonably allowed Employee 1 to resume trading in JL's accounts in February 2002. The record does not support this claim. While Respondent had told Employee 1 to cease trading in the accounts the previous summer, many months had passed with no trading. It certainly would not be reasonable to insist that trading cease forever in the accounts to avoid possible excessive or unauthorized trading. Moreover, the evidence shows that Respondent placed Employee 1 under heightened supervision in connection with the trading to prevent future misconduct. For example, Respondent exceeded Firm A's own procedures by requiring JL to sign Long Term Product Disclosure Statements[17] or give his consent in writing for several trades that involved a commission charge.

In addition, even though it was Employee 1's responsibility to recommend suitable trades to JL, Respondent ensured that there was a reasonable basis for Employee 1's recommendations. The bond funds that Employee 1 initially purchased for JL during this period were recommended by Firm A and were selling at a discount that gave JL a greater yield than he had prior to the trades. Similarly, the no-load municipal funds that Employee 1 purchased had a higher yield, and were tax-free. Under these facts, we conclude that Enforcement has not demonstrated that Respondent failed to take appropriate supervisory action.[18]

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[17] By signing these documents, JL explicitly acknowledged that he was selling certain funds with whose performance he was unhappy; that he was purchasing different funds with the hope of improving his position; that he was aware of specified deferred sales charges associated with these funds; and that he was authorizing the transactions.

[18] We acknowledge that Respondent's decision to allow Employee 1 to resume trading in JL's accounts was troubling, given that Employee 1 apparently had significant influence over JL. This influence is evidenced by the fact that Employee 1 had previously been able to convince JL to rescind his complaint while the matter was still under investigation by Firm A. Under the totality of facts, however, we find that Respondent's response was reasonably designed to prevent the underlying excessive trading and unauthorized trading violations at issue in this case. *See Bellows*, 1998 SEC LEXIS 1521, at *24-25) (finding no supervisory liability where supervisor's actions were reasonably designed to prevent the violations at issue) (*citing Louis R. Trujillo,* 49 S.E.C. 1106 (1989)).

V. Conclusion

We find that Enforcement failed to establish by a preponderance of the evidence that Respondent's supervision of Employee 1 was unreasonable. We reject Enforcement's arguments that Respondent ignored several red flags and failed to take reasonable steps to address these red flags in violation of NASD Conduct Rules 3010 and 2110.[19] We therefore affirm the Hearing Panel's findings that Respondent is not liable for these violations.

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President and Corporate Secretary

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[19] We have also considered and reject without discussion all other arguments advanced by the parties.