BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Richard G. Cody, Boston, MA, Respondent.	DECISION Complaint No. 2005003188901 Dated: May 10, 2010

The Hearing Panel found that respondent made quantitatively and qualitatively unsuitable recommendations, sent customers misleading and unapproved account summaries, and failed to update timely his Form U4. Held, the Hearing Panel's findings are affirmed in part, reversed in part. Sanctions are increased.

Appearances

For the Complainant: Leo F. Orenstein, Esq., Paul Taberner, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Stephen Z. Frank, Esq.

Decision

On January 29, 2009, a Hearing Panel found that Richard G. Cody ("Cody") recommended transactions in customer accounts that were quantitatively and qualitatively unsuitable; sent to customers misleading and unapproved account summaries; and failed to update timely his Uniform Application for Securities Industry Registration or Transfer ("Form U4") to disclose two settlements with customers. For the suitability violations, it fined Cody $20,000 and suspended him for three months. For the misleading and unapproved account summaries, it fined Cody $5,000. For the Form U4 violations, it fined Cody $2,500. Pursuant to NASD Rule 9311(a), the Department of Enforcement ("Enforcement") appealed the sanctions, including the Hearing Panel's decision not to award restitution.[1] Cody cross-appealed and

1 Following the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA, FINRA began developing a new

[Footnote continued on next page]

challenged the three-month suspension. We affirm in part and reverse in part the liability findings. We increase the suspension to a one-year suspension, and we affirm the $27,500 in fines. We also affirm the Hearing Panel's decision not to award restitution.

I. Background

Cody entered the securities industry in 1996. From December 2001 to May 2005, Cody was registered as a general securities representative with Leerink Swann & Co ("Leerink" or "the Firm"). From May 2005 until March 2010, Cody was registered with GunnAllen Financial ("GunnAllen"). He is currently registered with another member firm.

II. Procedural History

FINRA opened the investigation that led to this proceeding after Leerink notified FINRA that it had received complaints against Cody from four of his customers, JB and EB ("the Bs") and LD and RD ("the Ds"). On January 14, 2008, Enforcement filed a seven-cause complaint against Cody. Causes one, two, and five alleged that Cody made various unsuitable recommendations, in violation of NASD Rules 2310 and 2110 and IM-2310-2. Specifically, cause one alleged that Cody recommended that LD make quantitatively unsuitable trades. Cause two alleged that Cody recommended that JB make quantitatively unsuitable trades and numerous qualitatively unsuitable purchases of non-investment grade bonds. Cause five alleged that Cody made qualitatively unsuitable recommendations that the Ds and JB purchase an asset-backed security ("ABS").[2] Causes three and four alleged that Cody delivered unapproved and misleading account summaries to the Ds and Bs, in violation of NASD Rule 2110 and IM-2310-2. Cause six alleged that Cody willfully failed to update, or file an accurate, Form U4 disclosing a settlement agreement with his former employer concerning a forgivable loan, in violation of NASD Rule 2110 and IM-1000-1. Finally, cause seven alleged that Cody willfully failed to update his Form U4 with information about settlement agreements with the Ds and the Bs, in violation of NASD Rule 2110 and IM-1000-1.

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"Consolidated Rulebook" of FINRA Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See FINRA Regulatory Notice 08-57* (Oct. 2008). Because the complaint in this case was filed before December 15, 2008, the procedural rules that apply are those that existed on December 14, 2008. The conduct rules that apply are those that existed at the time of the conduct at issue.

2 Although the parties and the Hearing Panel have consistently referred to the security at issue in cause five as a "collateralized mortgage obligation," the security was an ABS, as explained in more detail below.

On January 29, 2009, the Hearing Panel issued an amended decision.[3] As alleged in cause one, it found that Cody made quantitatively unsuitable recommendations to LD. With respect to cause two, it found that Cody recommended that JB make quantitatively unsuitable trades and three qualitatively unsuitable purchases of non-investment grade bonds, but it implicitly dismissed the allegations that Cody's qualitatively unsuitable recommendations were broader. As for cause five, the Hearing Panel found that Cody's recommendations that JB and the Ds invest in an ABS were unsuitable. For causes three and four, the Hearing Panel found that Cody sent misleading and unapproved account summaries to the Ds and the Bs, in violation of NASD Rule 2110, but it did not address the allegations that such conduct also violated IM-2310-2. The Hearing Panel dismissed the allegations of Form U4 violations in cause six. As for cause seven, the Hearing Panel found that Cody failed to update his Form U4 with information about a settlement agreement with the Ds and the Bs, in violation of NASD Rule 2110, but it dismissed the allegation that Cody's failure was "willful," and it did not address whether Cody also violated IM-1000-1. The Hearing Panel suspended Cody for three months and fined him $20,000 for his suitability violations; fined him $5,000 for the use of misleading and unapproved account summaries; fined him $2,500 for his Form U4 violation; and ordered him to pay $7,087.50 in costs. The Hearing Panel declined to order restitution.

Enforcement appealed the sanctions, and argued that a bar and restitution should be imposed. Cody filed a cross-appeal, in which he challenged only the three-month suspension.[4] On appeal, the NAC Subcommittee informed the parties that it would also review the liability findings and permitted the parties to file supplemental briefs addressing such findings.[5]

III. Suitability Allegations – General Background

In this decision, the relevant facts and discussion are grouped by allegation. We start with providing the general background that pertains to the suitability allegations.

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[3] The Hearing Panel amended its decision to correct an error in the conclusion concerning the sanctions.

[4] During the appeal proceedings, Cody filed motions to dismiss Enforcement's appeal for failure to make proper service, to dismiss Enforcement's appeal for failing to comply with NASD Rule 9311, to limit the scope of Enforcement's appeal to the restitution issues, and to extend the time for filing requests to submit additional evidence. FINRA's Office of General Counsel ("OGC") or the NAC Subcommittee denied those motions, along with several motions for reconsideration. We have considered those rulings, and we adopt them as our own.

[5] Enforcement neither contested, nor addressed in its briefs, a number of allegations on which it did not prevail below. These issues include the Hearing's Panel's: (1) not addressing the allegations in causes three and four that Cody violated IM-2310-2; (2) dismissal of the allegations in cause six; (3) not addressing the allegations in cause seven of violations of IM-1000-1; and (4) dismissal of the allegation in cause seven that Cody's failure to update his Form U4 was "willful." As an exercise of our discretion, we do not reach these issues.

A. The Ds' Financial Background

Cody and RD met in 1998, via a cold call. RD subsequently introduced Cody to LD, his wife. Over the next several years, the Ds opened several individual and joint accounts with Cody and followed him as he moved to new firms. The suitability allegations that pertain to the Ds concern just two of the seven accounts they owned at Leerink: (1) a joint account, in which Cody recommended that the Ds purchase an ABS in February 2003; and (2) an IRA account owned by LD, into which she had rolled over a 401(k) account and in which Cody effected numerous trades from June 2003 through May 2004.

As of February 2003, LD was 56 years old, and had retired the previous August from her position as an operations and purchasing manager. RD was 59 years old, and either at or nearing retirement from his position as a field engineer. According to various account opening documents that the Ds completed between April 2002 and June 2004, LD's annual income was between $50,000 and $90,000, at least part of which came from a retirement package providing for two years of payments; RD's annual income was between $40,000 and $50,000; and the Ds had a net worth between $900,000 and $1,300,000. As of February 28, 2003, approximately when Cody recommended that the Ds purchase an ABS in their joint account, the value of that account was $242,784, according to the account statement. As of June 30, 2003, when the allegedly excessive trading in LD's IRA commenced, that account was worth $460,563 (according to the account statement) and was the Ds' largest account. At that time, the total value of the Ds' Leerink portfolio was $840,000, which represented approximately 90 percent of their liquid assets.

In late 2002 and early 2003, the Ds' financial needs centered on how they planned to fund their retirement, especially when the payments from LD's retirement package would cease. The Ds informed Cody that, beginning in January 2005, they would need to withdraw approximately $72,000 per year from their portfolio. Based on their discussions with Cody, the Ds expected that approximately $20,000 would come from principal, and the rest would come from investment income. After five years of such withdrawals, when the Ds would be eligible for social security, they planned to lower their annual withdrawal to $65,000 and cease drawing from principal.

There is conflicting evidence concerning how aggressively the Ds wanted to pursue those goals. LD testified that the Ds primarily sought "income." She testified that the Ds asked Cody to invest their funds—including the funds in LD's IRA—primarily in income-producing, fixed-income securities that were "safe triple A, double A" rated securities and that would mature in approximately 10 years.[6] LD also noted that Cody had informed her that "if you want your

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6 The record demonstrates that from February 3, 2003, to May 31, 2004, the average yield on Moody's Aaa rated (investment grade) seasoned corporate bonds ranged from 4.84% to 6.13%, and that in February 2003—when Cody recommended the ABS at issue—the average yield ranged from 5.89% to 5.99%.

investments to grow without much risk, bonds is the way to go." At other points in her testimony, however, LD indicated that the Ds were seeking something somewhat more aggressive than income and low risk, at least for a portion of their portfolio. LD acknowledged that her IRA's account opening documents accurately reflected that she sought long-term growth and moderate risk.[7] The account opening documents for the Ds' joint account reflected an investment objective of long-term growth and a risk tolerance of speculation. LD explained that she expected to achieve "growth" by not withdrawing any income from the Ds' accounts until they needed to, and that she was "happy" investing in bonds that paid "seven, eight," and "sometimes . . . ten" percent interest. Asked why several of the Ds' account opening documents reflected a risk exposure of speculation, LD responded that the Ds "didn't read the whole [documents]." Yet LD elsewhere acknowledged that the Ds "were willing to be more aggressive" with a portion of their portfolio (primarily in a separate "managed account" she had opened) "to try to . . . appreciate it." Considering that the Ds did not plan to make withdrawals until January 2005, Cody's understanding in 2003 was that the Ds had two years "to try to build up as much cash as possible" and obtain "appreciation in some of the bonds, if possible."

Prior to working with Cody, RD and LD had about 15 and 20 years of investment experience, respectively, primarily in their 401(k) accounts. LD had owned mutual funds in her 401(k) account, but had no other experience with mutual funds or bonds. The Ds also had owned savings and credit union accounts, savings bonds, and a small joint account held with another broker-dealer. LD also testified that RD was "sort of heavy into tech stocks" at some point, but provided no specifics. According to Cody, the Ds also had small holdings in direct investment plans.

After opening accounts with Cody but prior to the start of the relevant period, the Ds gained at least some minimal exposure to bond investing. The Ds had owned some bonds in the joint Leerink account, and LD had owned some fixed income investments in both her Leerink IRA and an individual account that she held with another broker-dealer. Nonetheless, LD possessed an unsophisticated and somewhat faulty understanding of bond investing. LD "knew that bonds generated income," but she "didn't know the ins and outs of it." LD also understood that bonds had different "risk ratings." LD further testified that Cody told the Ds, "if you want your investments to grow without much risk, bonds is the way to go." LD also recalled that Cody had mentioned the terms "mark up" and "mark down," but she did not have a "good understanding of it." RD did not testify at the hearing.

B. JB's Financial Background

Around January 2003, the Ds referred their friends JB and EB, husband and wife, to Cody. JB was 69 years old and retired from his job in research and development. EB was 63 years old and retired from her position as a supervisor in a company's accounting department.[8]

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[7] The investment objectives options were "income," "long-term growth," and "short-term trading." The risk exposure options were "low," "moderate," "speculation," and "high risk."

[8] EB returned to work from September 2003 through May 2004.

At the time, JB held a 401(k) account with his prior employer. Concerned that his prior employer might be acquired, JB sought to locate a specialist to manage his investments. In February 2003, JB opened an IRA with Cody. Subsequently, EB opened an IRA and a separate "managed account" IRA. The suitability allegations concern only the IRA owned by JB.

The record contains inconsistent information concerning JB's financial situation during the relevant period. According to account opening documents for his IRA, as of January 2003, JB's annual income was $55,000 and his liquid net worth was $150,000, which purportedly included his wife's assets. Other facts, however, show that his family's net worth was higher. For example, in February and June 2003, JB rolled $409,000 into his IRA, mostly from his 401(k) account. In addition, EB's account opening documents for her two accounts, dated May 29 and October 29, 2003, reflect that EB had an annual income between $30,000 and $55,000 and a liquid net worth between $625,000 and $950,000.

JB testified that he was not trying to increase the value of his account. Rather, JB informed Cody that he hoped to generate $2,000 in monthly income in his IRA. JB's account opening documents reflected an investment objective of "income" and a desired risk exposure of "low." According to JB, Cody told him that generating $2,000 in monthly income would not be a problem, and that bonds would be an appropriate investment.

According to JB's account opening documents, JB had 20 years of investment experience, primarily in his 401(k) plan. JB testified that he had little experience with bonds. The Bs testified that, prior to working with Cody, they also had owned a joint account at another broker-dealer in which they held stocks, bonds, and REITs, and that EB owned an individual account with the same broker-dealer. There is no other evidence concerning those accounts.

IV. Qualitative Suitability Allegations: Reasonable Basis and Customer Specific Suitability

A. Cody Recommends that JB and the Ds Purchase an ABS

On February 6, 2003, immediately after JB opened his IRA, Cody invested $86,254 of that IRA (approximately 22.7% of JB's initial rollover contribution) in the mezzanine tranche of the "Credit Suisse First Boston Mortgage Securities Corp. IndyMac Manufactured Housing Passthru CTF 97-1 M," an ABS. On February 25 and 27, 2003, Cody invested approximately $31,000 of the Ds' joint account (12.9% of the account value as of February 28, 2003) in the same ABS. The coupon rate for the ABS was 7.10%, and the stated maturity date was February 2028.[9] When issued in 1997, the mezzanine tranche was $11.9 million in size and eighth in seniority. The collateral was fixed rate manufactured housing installment sales contracts and installment loan agreements.[10]

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[9] Cody testified that the ABS was purchased "at a discount," and estimated that the yield was approximately ten percent.

[10] Such collateral is one of the reasons why this security was an ABS, not a collateralized mortgage obligation. *See* Andrew S. Carron, *Asset-Backed Securities*, in *The Handbook of Fixed*

[Footnote continued on next page]

Cody learned about the ABS from Leerink representative Tim Skelley ("Skelley"). Cody testified that Skelley was a fixed income specialist who maintained relationships with outside traders. According to Cody, Skelley informed the Firm's retail group that the ABS was a good investment for applicable clients. Skelley explained that the ABS was "an asset-backed security supported by mortgages on homes"; paid principal and 7% interest; and would likely mature in just six to seven years due to prepayments of the underlying "mortgages."[11] Cody testified that Skelley "seem[ed] knowledgeable" and that the investment "[s]eemed like a pretty good idea" considering the interest rate, the expected maturity, and the facts that it was "trading at a discount" and "A rated." Less than one day after learning about the ABS, Cody recommended it to the Ds and JB without having further discussions with Skelley or gathering any more information.

When Cody recommended the mezzanine tranche of the ABS, it had an investment grade rating. Within five months, however, the rating fell below investment grade, it continued to plunge thereafter, and the price fell dramatically. Cody testified that he was concerned that the price might "go[ ] to zero" and that the customers "certainly didn't want that." On February 24, 2004, Cody sold the Ds' ABS, and they realized a capital loss of $17,374, which was 55% of their investment. Likewise, in three transactions in February, April, and May 2004, Cody sold JB's ABS, generating a realized capital loss of $56,868, which was 66% of JB's investment. During the time they owned the ABS, the Ds and JB received approximately $5,000 and $12,000 in interest, respectively.

B. Cody Purchases Three Non-Investment Grade Bonds in JB's IRA

Cody purchased three non-investment grade bonds in JB's IRA. In May 2003, he purchased approximately $45,000 of non-investment grade Ahold Financial USA Inc. ("Ahold") bonds. In June 2003, Cody purchased approximately $25,000 of non-investment grade Royal Caribbean Cruises, Ltd. ("Royal Caribbean") bonds, and approximately $37,000 of non-investment grade Calpine Corp. ("Calpine") bonds. Cody sold the Calpine bonds in July 2003, the Ahold bonds in September 2003, and the Royal Caribbean bonds in November 2003, realizing a total of approximately $2,000 in gains.

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Income Securities 654-66 (Frank J. Fabozzi, ed., 3d ed. 1991) ("Asset backed securities are supported by installment loans or leases or by revolving lines of credit."); *About MBS/ABS, What are Asset-Backed Securities* (2010), *available at* www.investinginbonds.com (last visited Jan. 6, 2010). Indeed, the security was identified on the customers' account statements as an asset-backed security.

[11] Cody testified that Skelley had also provided him with a Bloomberg printout concerning the ABS, but that—according to Cody—it contained no more information than the limited information Skelley had described.

C. Qualitative Suitability Discussion

The Hearing Panel found that Cody's recommendations that JB and the Ds purchase an ABS, and that JB purchase several non-investment grade bonds, were unsuitable. For the reasons set forth below, we affirm.

NASD Rule 2310 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."[12] Thus, a broker "must have reasonable grounds to believe that the recommendation is suitable for the specific customer at issue," an obligation that is referred to as "customer-specific suitability." *Dep't of Enforcement v. Medeck*, Complaint No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *31 (FINRA NAC July 30, 2009); *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *23 (Feb. 10, 2004). A broker's recommendations must be consistent with his customer's best interests, financial situation, and needs, and he or she "must abstain from making recommendations that are inconsistent with the customer's financial situation." *Faber*, 2004 SEC LEXIS 277, at *23-24.

Before making a customer-specific suitability determination, a registered representative "must first have an 'adequate and reasonable basis' for believing that the recommendation could be suitable for at least some customers," an obligation that is often referred to as "reasonable-basis suitability." *Michael Frederick Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *28 (Oct. 6, 2008), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. 2010); *Medeck*, 2009 FINRA Discip. LEXIS 7, at *3. "The reasonableness of any recommendation is predicated on a registered representative's understanding of the potential risks and rewards inherent in that recommendation." *Siegel*, 2008 SEC LEXIS 2459, at *28 (internal quotation marks omitted). "[A] broker may violate the suitability rule if he fails so fundamentally to comprehend the consequences of his own recommendation that such recommendation is unsuitable for any investor, regardless of the investor's wealth, willingness to bear risk, age, or other individual characteristics." *Id.* (internal quotation marks omitted).

1. ABS Purchases

We first address Cody's recommendations that JB and the Ds purchase ABSs. Asset-backed securities are bonds or notes backed by financial assets, typically receivables other than

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[12] Pursuant to NASD Rule 0115(a), NASD rules that apply to "members" are applicable to associated persons.

mortgage loans.[13] The financial assets that backed the ABSs that Cody recommended were manufactured-housing installment sales contracts and installment loan agreements.

When recommending a structured product such as an ABS, a representative fails to meet the "reasonable basis suitability" standard if he lacks an understanding of the factors that can affect the performance of the structured product. This understanding will go beyond knowing the structured product's yield and stated maturity and will include all important differences between the structured product and a plain vanilla corporate bond. A representative's due diligence efforts concerning a structured product—whether they consist of consultations with an in-house expert or otherwise—are insufficient to proceed with a recommendation unless they give the representative a fundamental understanding of the structured product.

For example, before recommending the mezzanine tranche of the ABS to *anyone*, it was incumbent upon Cody to understand that the ABS was a structured bond, and that the specific tranche he was recommending was subordinated to other tranches with respect to priority of payment. Cody also needed to gain an understanding of the difference between the stated maturity date and the estimated average life of the tranche he was recommending, and why such a difference existed. He also needed to understand that the ABS's higher yield over a conventional debt instrument was not solely a benefit, but was based on risks that he must comprehend.

Likewise, Cody was required to gain an understanding of the fundamental risks that would affect the performance of the ABS. One of those fundamental risks is credit risk, which is affected by a variety of factors. For example, the nature of the underlying collateral affects the credit risk. Credit risk is also influenced, in a multi-tranche deal, by the nature of the specific tranche involved. Higher classes of tranches are usually designed to minimize default risk, whereas lower classes are usually designed to absorb losses before the senior tranches and present a higher risk of default. Furthermore, unlike most bonds, an ABS's creditworthiness can be affected by a variety of internal and external "credit enhancement" supports. For example, the ABSs that Cody sold had an "overcollateralization" credit enhancement feature, which indicates that the "face amount of the [underlying] loan portfolio is larger than the security it backs." SIFMA, *About MBS/ABS: Credit Quality and Credit Enhancement* (2010), *available at* www.investinginbonds.com (last visited Jan. 6, 2010).

Another risk that ABSs present is prepayment risk. An ABS's offering price, market value, estimated yield, and estimated average life are based on assumptions about the rate at which the underlying collateral will be prepaid. Thus, ABSs are subject to the risk that the actual rates of prepayment will differ from the prepayment assumptions.

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[13] Except where otherwise noted, the statements in this section concerning ABSs generally rely on the following authorities: SIFMA, *About MBS/ABS* (2010), *available at* www.investinginbonds.com (last visited Jan. 6, 2010); Carron, *supra* note 10, at 654-66.

Cody also was required to comprehend the nature of the interest rate risk involved with the ABS before recommending it to any investor. As with any bond, when interest rates rise (or fall), the market price of most types of outstanding ABS tranches drops (or rises) in proportion to the time remaining to the estimated maturity. Some ABSs are also subject to another type of interest rate risk: the risk that a change in market interest rates may influence the pace of prepayments of the underlying loans. While not all ABSs are subject to this kind of prepayment sensitivity to interest rate changes, ABSs backed by manufactured-housing contracts are, despite the fact that the average balance of such contracts is much lower than that of a typical mortgage loan.

At the time Cody sold the ABSs to his customers, he did not comprehend how an ABS was different than a conventional fixed income instrument, did not understand the fundamental factors that would have affected its performance, and was in no position to know whether the ABS was suitable for any investor. When Cody testified about his understanding of the investment at the time of the sales, Cody listed only the potential rewards (such as the stated coupon rate and the credit rating), and essentially mentioned none of the fundamental risks.[14] Cody conceded that he did not know the "relative risk level" of the mezzanine tranche; what kinds of "mortgages" backed the ABS; or that the tranche had been downgraded (from Fitch's "AA" to "A") a few months before he sold it. Further reflecting his ignorance of the risks, Cody did not even explain to his clients which tranche they were buying. Indeed, when asked whether he "really understood" the ABS, Cody admitted, "no, not when I sold it" and added, "I didn't really look at [it] to be significantly different than any other bond."

Cody suggests that the fact that he learned of the ABS from the Firm's fixed income expert, Skelley, excuses his violation. It does not. A representative who recommends a structured product to customers does not shed his independent suitability-related responsibilities merely by consulting with an in-house expert about the product. Cody's due diligence shortfall was that he failed to press Skelley to describe the structure and risk characteristics of the ABS sufficiently to obtain a fundamental understanding of the factors that would affect the performance of the ABS.

Because Cody fundamentally failed to gain an understanding of the potential risks and rewards of the ABS that he was selling, his recommendations lacked reasonable-basis suitability in violation of NASD Rule 2310.[15] Likewise, Cody's recommendation lacked customer-specific suitability. Cody was required to have "reasonable grounds" for recommending the ABS to JB,

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[14] Cody demonstrated limited awareness of the prepayment risk, but seemed to view it only as a selling point. In this regard, Cody emphasized that the investment's expected maturity date within seven to eight years—which was based on prepayment assumptions—was of the length that LD sought.

[15] In finding that Cody lacked reasonable basis suitability to recommend the ABS, we are not suggesting that the ABS was not suitable for any investor. Our findings reflect only that *Cody* himself lacked the understanding to know if the ABS was suitable for any investor.

who sought low risk and preservation of capital, and the Ds, who—among other factors—had acknowledged on their joint account opening documents a risk tolerance of speculation. Cody, however, did not have reasonable grounds. He was in no position to evaluate whether the risks involved with the ABS were equal to or less than the risk tolerances of his customers, especially considering that his customers were not sophisticated fixed income investors.[16] Accordingly, we find that Cody's recommendations of the ABSs were unsuitable, in violation of NASD Rules 2310 and 2110.[17]

2. Non-Investment Grade Bonds

The Hearing Panel also found that Cody's recommendations of Ahold, Royal Caribbean, and Calpine non-investment grade bonds for JB's IRA were qualitatively unsuitable. We agree. Each of the three non-investment grade bonds was unsuitable for JB, considering that he was 69 years old and retired, sought low risk and immediate income, and needed to preserve capital. Cody compounded the unsuitability of these recommendations by overconcentrating JB's IRA in such bonds. Specifically, by June 30, 2003, those recommendations resulted in JB simultaneously owning all three of these non-investment grade bonds. These holdings were worth $108,575, or approximately 23.4% of JB's IRA account value. That JB ultimately realized small gains on these three investments does not transform Cody's recommendations into suitable ones. *Jack H. Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *14 (Feb. 10, 2003) ("Unsuitable recommendations . . . do not become suitable because they result in a profit.").

Cody argued that, because JB began withdrawing $2,500 to $2,750 per month—more than the $2,000 JB said he would withdraw—corporate bonds rated at Moody's Baa level "generated th[e] level of cash flow" that JB needed and were more appropriate than lower-

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[16] *Faber*, 2004 SEC LEXIS 277, at *24-25 (holding that a representative's recommendations must be consistent with the customer's financial situation, needs, and risk tolerance). Unlike the Hearing Panel, our finding that Cody's recommendation to JB lacked customer-specific suitability does not rely on the fact that it resulted in 22% of JB's IRA being invested in the ABS. "[H]igh concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk." *Id.* at *26. The record does not demonstrate, however, that the ABS tranche was a "speculative security" when Cody purchased it. At the time, the mezzanine tranche had a long-term credit rating that was investment grade. Furthermore, other than evidence that the yield for the mezzanine tranche was approximately three percentage points above the average yield for Moody's Aaa rated corporate bonds, the record contains little that specifically addresses the extent of the risk that the mezzanine tranche might lose market value. Considering the complexity of the ABS, expert testimony would have been helpful on this point.

[17] It is a "long-standing and judicially-recognized policy that a violation of another Commission or NASD rule or regulation . . . constitutes a violation of . . . [NASD] Rule 2110." *Stephen J. Gluckman*, 54 S.E.C. 175, 185 (1999).

yielding, less risky Aaa bonds. The three bonds at issue, however, were all rated *lower* than the Moody's Baa level, and were all non-investment grade. In any event, by focusing on the amounts that JB was withdrawing, Cody ignored that his recommendations exceeded the risk that JB was able and willing to take.[18] Cody also argued that, because his customers expressed a desire to avoid bonds that might be downgraded, he began to obtain bonds with "household names" such as the Royal Caribbean bond. Household names or not, the three bonds Cody purchased were already rated below investment grade, and were excessively risky for JB.[19]

Accordingly, we affirm the Hearing Panel's findings that Cody's recommendations that JB purchase non-investment grade bonds were excessively speculative and risky for JB, and therefore lacked customer-specific suitability in violation of NASD Rules 2310 and 2110.

V. Quantitative Suitability Allegations

We now turn to the Hearing Panel's findings that Cody made quantitatively unsuitable recommendations in JB's and LD's IRAs. We affirm the Hearing Panel's findings.

A. Cody Effects Numerous Transactions in JB's IRA

From February 2003 through May 2004, Cody effected 109 purchase and sale transactions in JB's IRA, 70 of which were purchases totaling approximately $1.7 million. These transactions generated $41,885 in commissions, of which $17,259 went to Cody. Cody primarily invested JB's account funds in fixed income securities, with smaller investments in equities and mutual funds. Specifically, between February 2003 and May 2004, Cody allocated between 66% and 97% of JB's account to fixed income securities.

The Hearing Officer refused to admit into evidence Enforcement's calculation of turnover and cost-to-equity ratios for JB's account, given a number of demonstrated errors in the underlying data. Nonetheless, the trades that Cody effected reflected an in-and-out pattern. No securities were held in the account for the entire relevant period. Nearly all of Cody's sales involved securities that had been held for less than one year, and most involved securities that had been held for less than three months.

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[18] Cody testified that JB wanted a "high return." That, however, is inconsistent with JB's testimony, who indicated that he sought to generate only $2,000 in monthly income in his IRA. Where testimony conflicted, the Hearing Panel credited the customers over Cody. The record does not contain substantial evidence for disturbing those credibility determinations.

[19] Enforcement suggests that the Hearing Panel incorrectly rejected its allegation that Cody's recommendations to purchase non-investment grade bonds were more extensive. To support that allegation, Enforcement introduced an exhibit showing the proportion of non-investment grade bonds that JB held on a monthly basis. The Hearing Panel correctly deemed that exhibit, however, to be of "no value" because it does not show the proportion of bonds that were non-investment grade at the time of purchase.

B. Cody Effects Numerous Trades in LD's IRA Account

From June 5, 2003, through May 27, 2004, Cody recommended and effected 140 buy or sell transactions in LD's IRA, 84 of which were purchases totaling more than $1.4 million. The average month-end equity in the IRA was approximately $421,000. Gross commissions, including mark-ups, exceeded $36,000, of which Cody received nearly $15,000. Initially, the account was primarily concentrated in fixed income investments, but the asset allocation evolved into one that was balanced between fixed income, mutual funds, and stocks. The annualized turnover ratio for the IRA was 3.40, and the cost-to-equity ratio was 8.7 percent.[20] Cody's sales often involved securities that were held for less than three months. Cody would often use sales proceeds to purchase promptly other securities. The only positions held in LD's IRA for the entire period were small holdings in two zero-coupon corporate bonds, and a single municipal bond that was worth $41,097 as of the end of the relevant period.[21]

C. Cody's Control of JB's and LD's IRAs

Although the record does not show that the Bs gave Cody written or oral discretion, they nonetheless knowingly allowed Cody to trade as if he had discretion. JB testified that Cody would place trades without first consulting them, that he would learn about the trades from the confirmations, and that he trusted Cody. EB, who participated in discussions with Cody about JB's account, testified that the Bs "didn't look at [their] accounts" and that, although she saw the confirmations of her account activity, she "wasn't paying any attention" because she was focused on issues related to her work and family. As for LD, she gave Cody oral discretionary authority to trade her accounts. LD testified that she "trusted [Cody] to say, 'hey, if a good deal comes up that you think is good, go ahead with it, and let us know afterwards." LD relied on Cody "to make appropriate investments [in her] accounts," and "95 percent of the time" Cody would not speak with her prior to making trades. Cody admitted that JB and LD relied upon and routinely followed his investment recommendations and deferred to him in almost all instances. Moreover, Cody ultimately conceded at the hearing that he did not speak to his clients about every specific trade in advance.

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[20] Unlike the calculations that Enforcement proffered for Cody's trading of JB's account, the turnover and cost-to-equity ratios it proffered concerning LD's account were reliable.

[21] Like the Hearing Panel, we make no findings concerning whether the alleged excessive trading in JB's or LD's IRAs generated losses. Enforcement introduced a chart showing that the investments that Cody both acquired and disposed of during the relevant period generated "realized" losses of $74,283 in LD's IRA account and $62,820 in JB's IRA account, the latter figure including the $56,868 loss that JB incurred on the ABS. That chart, however, did not account for any unrealized gains or losses.

D. Quantitative Suitability Discussion

The Hearing Panel found that Cody effected quantitatively unsuitable trades in JB's and LD's IRA accounts. We affirm those findings.

A broker is required to have "reasonable grounds to believe that the number of recommended transactions within a particular period is not excessive." *Medeck*, 2009 FINRA LEXIS 7, at *31. A finding of quantitative unsuitability requires a showing of: (1) "broker control over the account in question"; and (2) "excessive trading activity inconsistent with the customer's financial circumstances and investment objectives." *Id.* at *34. Factors such as the turnover rate, the cost-to-equity ratio, the presence of in-and-out trading, and the number and frequency of trades "introduce some measure of objectivity or certainty into the analysis and may provide a basis for a finding of excessive trading."[22] *Id.* at *42. Nevertheless, the "assessment of the level of trading . . . does not rest on any 'magical per annum percentage,' however calculated." *Gerald E. Donnelly*, 52 S.E.C. 600, 603 (1996).

1. Control

The Hearing Panel found that Cody controlled JB's and LD's IRA accounts. We agree. "Control may be established where a customer, although not granting his broker a formal power of attorney, so relies upon the broker that the latter is in a position to control the volume and frequency of transactions in the account." *John M. Reynolds*, 50 S.E.C. 805, 807 (1991). LD gave Cody oral discretionary authority to trade her account, and JB allowed Cody to trade his account as if he had such discretion. Cody did not discuss the trades with the customers before making them. Furthermore, the customers lacked experience and sophistication in bond trading, which is what the bulk of Cody's active trading involved, and the customers testified that they trusted Cody. Given these circumstances, we find that Cody had de facto control over LD's and JB's accounts. *Id.* at 807-08 (finding control over a church's account, where the church lacked sophistication, relied on the broker's expertise and integrity, and instructed the broker to do "whatever you think is going to make us money," and where the broker "traded first, and informed the [customer] later"); *see also Dep't of Enforcement v. Zaragoza*, Complaint No. E8A2002109804, 2008 FINRA Discip. LEXIS 28, at *16-19 (FINRA NAC Aug. 20, 2008)

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22 The turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment." *Rafael Pinchas*, 54 S.E.C. 331, 339-40 n.14 (1999); *Allen George Dartt*, 48 S.E.C. 693, 695 (1987). A modified formula divides the total cost of purchases by the average monthly equity. *Stein*, 2003 SEC LEXIS 338, at *17 n.26. The cost-to-equity ratio represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses[,]" such as margin interest. *Pinchas*, 54 S.E.C. at 340; *Medeck*, 2009 FINRA LEXIS 7, at *36 n.19; *Frederick C. Heller*, 51 S.E.C. 275, 276-77 (1993). "[I]n-and-out" trading refers to the sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities. *See Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).

(finding de facto control where broker traded account pursuant to oral authority to exercise discretion, and the customer trusted the broker); *Dep't of Enforcement v. Dunbar*, Complaint No. C07050050, 2008 FINRA Discip. LEXIS 18, at *22 (FINRA NAC May 20, 2008) (finding that a broker had control where he had a "certain amount of oral discretionary authority" and "traded the accounts as if he had open-ended discretion").

Pointing to our recent decision in *Medeck*, 2009 FINRA LEXIS 7, Cody argues that a showing of de facto control requires a showing that the customer follows the broker's advice "because the customer is unable to evaluate [the broker's] recommendations and to exercise . . . independent judgment," and further argues that Enforcement failed to make such a showing here. *Id.* at *34 (internal quotation marks omitted). Unlike the nature of the broker-customer relationship in *Medeck*, however, LD gave Cody oral discretionary authority, and JB allowed Cody to trade as if he possessed such authority. Regardless of whether LD and JB had the independent ability to evaluate Cody's recommendations, Cody did not discuss his recommendations with his customers in advance. Such circumstances are nearly tantamount to a formal grant of discretionary authority. Accordingly, we find that Cody controlled JB's and LD's IRAs. *See Heller*, 51 S.E.C. at 278 & n.7 (rejecting the argument that the "control" issue, in a case where the broker actually exercised oral discretionary authority, looks to whether "the customer has the ability to control the account"); *see also Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676 (9th Cir. 1982) (holding that "[i]f a broker is formally given discretionary authority to buy and sell for the account of his customer, he clearly controls it").[23]

2. Quantitatively Unsuitable Trading

The record shows that the trading in JB's IRA was quantitatively excessive, considering his financial situation and investment objectives. JB was 69 years old and retired, his annual income was at least $55,000, and his family's net worth was as high as $950,000. JB informed Cody that his goal for his IRA, in which he had invested approximately $409,000, was to immediately generate income of $2,000 per month to help fund his retirement. JB's investment objective was income, and his desired risk exposure was low. JB understood that Cody would use bonds to generate the annual income he sought.

Although Enforcement failed to introduce reliable turnover and cost-to-equity calculations for the trading in JB's IRA, it is apparent that Cody's trading of JB's IRA was active

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[23] In any event, the record shows that the customers *were* unable to evaluate Cody's active trading of their accounts. The record shows that both LD and JB lacked sophistication or significant experience in bond trading, let alone active bond trading. Furthermore, the record shows that Cody informed LD and the Bs that they would not be paying commissions on bond transactions, but omitted that they would be paying mark-ups and mark-downs. That omission necessarily affected the customers' ability to evaluate the level of trading in their accounts. Although Cody points to the fact that LD and EB personally conducted detailed reviews of, and asked Cody questions about, the account activity after the active trading period, that does not demonstrate that the customers were able to evaluate such activity as it was occurring.

and excessive, considering JB's financial situation and conservative needs. From February 2003 through May 2004, Cody effected 109 purchase and sale transactions, no securities were held over the entire relevant period, and most of the transactions involved securities that had been held for only three months or less. It is also telling that the nearly $42,000 in commissions that Cody's trading generated over the relevant 15-month period exceeded the approximately $30,000 in income that JB sought to earn over the same period. On top of that, JB specifically testified that he did not expect the amount of trading that took place in his account. Indeed, we see no reason how trading this active was consistent with the conservative approach that JB sought and needed. *See Costello*, 711 F.2d at 1369 n.9 (holding that in-and-out trading "is a practice extremely difficult for a broker to justify").

Cody tried to justify his active trading of JB's IRA with the same excuse he gave for recommending the non-investment grade bonds: JB began withdrawing more from his account than he said he would, which Cody interpreted as JB wanting a "high return." That JB began withdrawing more from his account, however, did not change JB's low tolerance for risk. If anything, JB's increased withdrawals magnified the need to maintain principal. We therefore find that Cody excessively traded JB's account, in violation of NASD Rules 2310 and 2110.[24]

Likewise, the preponderance of the evidence demonstrates that Cody excessively traded LD's IRA account. The turnover rate for LD's account was 3.4, and the cost-to-equity ratio was 8.7 percent. While these figures are lower than what are usually held to be conclusive or presumptive evidence of excessive trading,[25] LD's financial circumstances demanded that Cody trade her IRA account in a manner that was more likely to preserve her capital. LD's account was a retirement account, and LD expressly told Cody that she needed to begin making withdrawals from her portfolio in just two years to fund her retirement. Short-term trading that

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[24] Cody argues that it is improper to base findings of quantitative unsuitability on a limited period of time within the life of an account, except where there has been a "drastic change in strategy." The SEC, however, has held that it is "appropriate [in excessive trading cases] . . . to review the trading done over a reasonably abbreviated portion of the entire period" that the broker managed the account. *Stein*, 2003 SEC LEXIS 338, at *18 n.30; *see also Peter C. Bucchieri*, 52 S.E.C. 800, 805 (1996). The SEC also has rejected arguments similar to Cody's that, where the customer maintains more than one account with the respondent, it is improper to make findings of excessive trading based only on the trading in a single account. *See Heller*, 51 S.E.C. at 279 (holding that findings of excessive trading are not required to be based on the "total assets for which the [respondent] was the registered representative," especially where the account at issue was an IRA that "should have been treated discretely").

[25] "[I]t has been generally recognized that an annual turnover rate of greater than six evidence excessive trading," although the Commission also has found turnover rates of less than six to indicate excessive trading. *Stein*, 2003 SEC LEXIS 338, at *16 (citing *Bucchieri*, 52 S.E.C. at 805); *Michael H. Hume*, 52 S.E.C. 243, 245 n.5 (1995) (noting that turnover rates of 3.5 and 4.4 were found to be excessive in past cases). The Commission has explained that "a cost-to-equity ratio in excess of 20% indicates excessive trading." *Pinchas*, 54 S.E.C. at 340.

required an 8.7% annual appreciation in LD's account merely to break even was inconsistent with LD's financial situation and needs. Indeed, the $36,000 in transaction costs that Cody's trading generated amounted to half of the first $72,000 annual withdrawal LD planned to make just two years later.

Moreover, the level of trading in LD's IRA account was inconsistent with LD's stated account objectives and desired risk exposure. On her account opening documents, LD chose the investment objective of "long term growth." Significantly, she did *not* choose the more aggressive investment objective of "short term trading." Yet short-term trading is exactly what Cody effected. Likewise, LD chose "moderate" risk exposure, not the more aggressive risk exposure options of "speculation" or "high risk." In-and-out trading at a level that ensured that LD would lose capital unless her account experienced an annual appreciation of at least 8.7% was not consistent with moderate risk.[26] Considering LD's investing objectives and financial situation, the demonstrated turnover and cost-to-equity ratios, and the in-and-out trading, Cody excessively traded LD's account, in violation of NASD Rules 2310 and 2110. *Cf. Gerald E. Donnelly*, 52 S.E.C. 600, 602-04 (1996) (finding that broker excessively traded a customer's account, where the customer sought "long-term growth" and where the broker pursued an "aggressive short-term trading strategy" with turnover ratios between 3.1 and 3.8); *Dep't of Enforcement v. Zaragoza*, 2008 FINRA Discip. LEXIS 28, at *19-23 (finding that broker excessively traded a customer's retirement account).

VI. Allegations of Misleading and Allegedly Unapproved Account Summaries

We now turn to the Hearing Panel's findings that Cody sent the Ds and Bs unapproved and misleading summaries of their account holdings. We reverse the findings that Cody sent unapproved summaries, but affirm the findings that he sent misleading summaries.

A. The Ds' and the Bs' Account Summaries

Cody sent to the Ds at least 24 account summaries—referred to as "ladders"—between June 19, 2003, and May 25, 2005; at least 22 ladders to JB between August 27, 2003, and May 25, 2005; and at least 20 ladders to EB between November 6, 2003, and May 25, 2005. Cody testified that, in general, he would mail the ladders.

Cody began sending the ladders for various reasons. JB testified that Cody began sending ladders after the Bs informed Cody that they had trouble understanding their account statements. The Ds asked Cody to provide them with something that would give a clearer picture of their investments and their investment income than their account statements. Cody

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[26] Cody offered several general rationales for why he sold bonds in the customers' accounts, some of which, if true, might have offered legitimate grounds for individual bond sales. Cody, however, made no attempt to demonstrate how each individual transaction served those rationales. Nor did he show how those rationales would have justified the amount of trading and costs involved.

testified that he began sending the ladders to give the customers a better idea of how "their money was working for them." In this regard, Cody believed that the customers' account statements did not show the ABS interest payments or how certain zero coupon bonds in the accounts were purportedly growing in value.[27]

Initially, the ladders sent to the Ds and JB included information only about their fixed income positions. For each bond, the ladders listed the issuer, the interest rate, the maturity date, and the "quantity." Significantly, the ladders did not define "quantity," but the record demonstrates that the amounts Cody used were the bonds' par values. The ladders also charted the purported amount and timing of income that each bond was expected to generate, on both a monthly and annual basis. In addition, the ladders included a "total" figure that was a sum of the bonds' "quantities" (i.e., the par values), and an "average" or "total" interest rate of the bonds. Cody testified that these initial ladders were designed to show the customers "how much income they were getting" from their investments and "when they were getting it." Cody testified that he did not initially include the bonds' market values because they had "nothing to do with computing the interest payments" that were charted on the ladders.

Beginning in September 2003 for the Ds' ladders and in November 2003 for the Bs' ladders, Cody changed the content in ways that Enforcement alleged made the ladders misleading. Per LD's request, Cody added to the Ds' ladders information about their non-fixed income investments. In doing so, Cody listed the market values of those non-fixed income investments. For the fixed income holdings, however, Cody continued to use only the par values as the "quantities," with no express indication that he was doing so. Cody also began to include on these ladders a "total portfolio" value, which summed the market values of the Ds' non-fixed income holdings and the listed "quantities" of the Ds' fixed-income holdings (i.e., the par values). Similarly, Cody added to the Bs' ladders the cash positions they held, continued to use only the par values as the "quantities" of their fixed income investments, and added a "total" account value with no express indication that that total combined market values for some holdings and par values for the bond holdings. In December 2003, Cody also began to include on EB's ladders the market value of the managed IRA account she had recently opened and incorporate that figure into the "total" calculation.

As a result of these changes and the differences between the bonds' par and market values, the "totals" on the Ds' and JB's ladders were substantially incorrect. The "total portfolio" amounts on the Ds' ladders between September 2003 and July 8, 2004, overstated the actual value of the Ds' portfolio by 24% to 46%. The "total account" amounts on JB's ladders between November 2003 and September 28, 2004 overstated JB's IRA value by 8.7% to 36%.[28]

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[27] For example, although the ABSs paid interest, the Ds' account statements showed that only as "accrued interest."

[28] Significantly less in degree were the differences between the "total" amounts on EB's ladders between November 6, 2003, and September 24, 2004, and the amounts listed on her closest account statements. Nine ladders overstated EB's most recent portfolio value between

[Footnote continued on next page]

Beginning July 13, 2004, for the Ds' ladders and November 2004 for the Bs' ladders, Cody again changed the content. Cody began including a column that showed the market values for each fixed income position and a second "total" figure that summed the market values for all listed investments. Cody added the market value column at the customers' request.[29] Enforcement does not allege that these ladders were misleading.

In addition to its allegations about the incorrect "totals," Enforcement also alleged that EB's ladders included misleading information about specific bond positions. EB's ladders dated February 4 and March 1, 2004, reflected that she held C Financial bonds in the quantity of "$20,000," but her account statements indicated that she owned only "10,000" C Financial bonds, which were valued at $10,252.80 and $10,719.70, respectively, as of January 31 and February 28, 2004. EB's ladders dated March 1, March 30, May 3, June 28, and August 10, 2004, reflected that she owned either "$10,000" or "$20,000" of a "Merrill Lynch/6.5%" bond, but her account statements reflected that she owned no such bond as of those dates. Likewise, EB's bond ladder dated September 7, 2004, reflected that she owned a "Merrill Lynch/8.5%" bond in the amount of "$20,000," but her account statements showed that she owned "20,000" Merrill Lynch zero coupon bonds, which were valued at $3,860 as of August 31, 2004.

B. The Bs' Account Activity Sheets

In June 2004, Cody sent to the Bs four "account activity" sheets, which listed the Bs' year-to-date sales of securities, the accompanying profits or losses, and some explanatory notes. EB testified that the sheets were intended to show why the Bs "were losing money" in their accounts. The Bs' account activity sheets indicated that on May 12, 2004, they sold Electronic Data Systems Corp. bonds ("EDS bonds") because they had been "called." Those bonds, however, had not been called.

C. Correspondence Approval Procedures

None of the ladders or account activity sheets in the record bears any notation indicating that such correspondence had been approved by a Leerink principal, supervisor, compliance officer, or anyone else. Leerink's written supervisory procedures that governed as of February 2004—the only manual in the record—contained two relevant correspondence approval provisions. One provision was in the "Financial and Operational Activities" section, and required that all outgoing written correspondence "be reviewed by the supervisor of the

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[cont'd]

0.4% and 5.8%, and three ladders understated EB's most recent portfolio value by 0.5%, 1.9%, and 36%.

[29] LD testified that, at some point, she "started to realize . . . that the bonds could go down" in value and told Cody that the ladders were not "giving [her] a true understanding of [her] assets."

particular business function or his designee before delivery to a designated person for distribution or transmission" and that "[a] notation . . . be made on an internal record of the daily review by an authorized supervisor/principal." The second provision was in the "RR and Associated Person Activities" section and provided almost identical guidance, except for specifying that the correspondence review would be performed by "a designee of the Chief Compliance Officer."

Two Leerink employees testified about the correspondence approval process. Paula Provenzano ("Provenzano"), who worked in the compliance department during the relevant period, testified that Cody was required to obtain approval of his correspondence from his retail manager, and that the compliance department only "spot-check[ed]" outgoing correspondence for compliance with that requirement. In contrast, John McPhee ("McPhee"), who became Cody's retail manager in the middle of the relevant period, testified that the correspondence approval responsibility was a dual one between the retail supervisor and the compliance department.[30] McPhee also testified that once a form letter had been approved, such approval was sufficient for subsequent mailings provided that there were "no changes." McPhee testified that Cody never sought his approval of the ladders.

Like McPhee, Cody understood that his retail supervisor and the compliance department shared the correspondence approval responsibility. Cody testified that the first time he mailed one of the ladders, both his supervisor at the time—Mazza—and the compliance department had approved it. Cody further understood that he was only required to place subsequent ladders in a mailroom bin for the compliance department's review. Cody testified that he had done so and expected to be made aware of any problems, although he acknowledged that "when I added more information [to the ladders]. . . maybe I should have done it differently." Cody did not recall anyone having to "initial" his ladders.[31]

D. Account Summaries Discussion

1. Misleading Summaries

The Hearing Panel found that Cody sent misleading account statements to the customers, in violation of NASD Rule 2110. We affirm.

Creating a document that misrepresents the true state of a customer's account "is the antithesis of a registered representative's [duty to uphold] high standards of commercial honor,"

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30 During the relevant period, Cody had three retail sales managers: Jeffrey Mazza ("Mazza") (late 2001 – March 2004), Lee Affee (March 2004-June 2004), and McPhee (beginning in June 2004).

31 While Cody acknowledged that faxes "had to be signed off on first" by any principal, he testified that he mailed nearly all ladders to the Ds and Bs, and did not indicate that he sent any by facsimile.

and a violation of NASD Rule 2110. *Dep't of Enforcement v. Abbondante*, Complaint No. C10020090, 2005 NASD Discip. LEXIS 43, at *31-32 (NASD NAC Apr. 5, 2005) (citation omitted), *aff'd*, Exchange Act Rel. No. 53066, 2006 SEC LEXIS 23 (Jan. 6, 2006), *petition for review denied*, 209 Fed. App'x 6 (2d Cir. 2006).

The ladders that Cody sent to the Ds between September 2003 and July 13, 2004, and to JB from November 6, 2003, to September 28, 2004, were misleading because they presented what appeared to be total account or total portfolio values that were substantially inaccurate. When Cody began to include on the ladders the market values for the customers' individual cash and equity positions without indicating that the "quantities" included for the fixed income positions were par values, the "totals" on those ladders falsely appeared to reflect the market value of the customers' accounts. Even worse, those total values significantly overstated the aggregate market value of those customers' holdings: the Ds' ladders overstated the value of their portfolio between 24% and 46%, and JB's ladders overstated the value of his account between 8.7% and 36%.

Enforcement failed to demonstrate that the "total" values on EB's ladders were materially misleading.[32] Nevertheless, EB's ladders were misleading to the extent that they reflected that she held specific bonds or quantities that, in fact, she did not hold. Those errors conveyed that EB had between $10,000 and $20,000 more in her account than she actually did.

We further find that the Bs' account activity summaries were misleading because they conveyed false information concerning the reason why the EDS bonds had been sold. By indicating that the EDS bonds were called, Cody falsely indicated that the sales were involuntary, rather than due to his exercise of discretion.

At the hearing, Cody argued that the context in which the ladders were presented prevented them from being misleading. In this regard, he claimed that when he reviewed the ladders with his customers, he did so in conjunction with their account statements and confirmations. Furthermore, he testified that the ladders originated as a tool to present only the expected income from the bonds, not the market values of individual holdings or the accounts. Cody's arguments lack merit. Once Cody began to incorporate into the ladders market values for only the non-fixed income instruments while continuing to use only par values for the fixed income "quantities," the total account or portfolio values became misleading on their face. Moreover, whatever he presented or explained to the customers did not prevent them from being misled. The Ds and JB testified that they understood the total portfolio and total account amounts on the violative ladders to reflect what the accounts were worth. Further showing LD's confusion, she testified that she would vainly try to "verify [the ladder] against the statement." Likewise, JB testified that he relied on the ladder in evaluating his account's performance and

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[32] The total values on EB's ladders were not demonstrably inaccurate, considering that they generally overstated or understated the values on the closest account statements by only a few percentage points or less, and that the ladders and account statements were sometimes dated several days apart.

did not understand that the ladders did not reflect the market value of his account. And EB specifically complained that the ABS entries on JB's ladders did not show the ABS's substantially deteriorating market value. Indeed, the fact that Cody subsequently changed the ladders' content to add the bonds' market values appears to have been a direct reaction to the customers' confusion. Accordingly, we affirm the Hearing Panel's finding that Cody sent misleading ladders to the customers, in violation of NASD Rule 2110.

2. Unapproved Summaries

The Hearing Panel found that Cody failed to obtain prior supervisory approval before sending the ladders as required by the Firm's written supervisory procedures, in violation of NASD Rule 2110. We reverse.

Enforcement alleged that the Firm's procedures required Cody to obtain prior approval of the ladders and account activity summaries from his retail manager, and that he failed to do so. In defense, Cody argues that he sought and obtained Mazza's and the compliance department's approval for the first ladder he sent out, delivered all subsequent ladders to the compliance department for approval, and believed that he had acted in accordance with the Firm's correspondence approval policies.

The record does not demonstrate what the Firm's correspondence approval policy was during the relevant period, or that Cody's actions were inconsistent with the Firm's policy. The record does not contain the procedures that governed during the initial part of the relevant period, when Cody first began sending ladders. While the Firm's February 2004 procedures are in the record, that manual contains two provisions that conflict concerning whether the retail supervisor or the compliance department shouldered the correspondence approval responsibility. Provenzano and McPhee provided conflicting testimony about that same issue, and were not asked to address the conflicting provisions in the manual. In addition, nothing in the manual clearly specifies what a registered representative's individual responsibility was beyond delivering the correspondence to whoever had responsibility for approving it. Moreover, while we can safely say that the Firm's procedures required at least one of Cody's ladders to be approved by someone, and while no ladders in the record bear evidence of approval, it is not clear that the Firm searched for copies of approved ladders in the files where the manual required that approved correspondence be maintained. Given all these evidentiary gaps and conflicts, we reverse the Hearing Panel's findings that Cody failed to comply with the Firm's correspondence approval procedures.

VII. Allegations Concerning Failures to Make Disclosures on Form U4

A. Factual Background

After Cody left Leerink in May 2005, the Ds and Bs raised concerns with Leerink managers about their accounts, particularly Cody's recommendation of the ABSs. Cody ultimately settled those complaints in August and September 2005, agreeing to pay $20,000 to the Ds and $56,000 to the Bs. Cody's Form U4 was not amended to reflect these settlements until September 2007.

B. Discussion

The Hearing Panel found that Cody failed to update his Form U4 to reflect that he entered into a settlement with the Ds and the Bs, in violation of NASD Rule 2110. We affirm.

The Form U4 required that Cody disclose the two settlements. At the time, Question 14I(2) on Form U4 asked, "Have you ever been the subject of an investment-related, consumer initiated complaint, not otherwise reported under question 14I(1) above, which alleged that you were involved in one or more sales practice violations, and which complaint was settled for an amount of $10,000 or more?" Although NASD By-Laws required Cody to update his answer to this question within 30 days of the settlements, he failed to do so for approximately two years. *See* NASD By-Laws, Art. V, Sec. 2(c). During that time, Cody's Form U4 was misleading. Accordingly, Cody's failure to update timely his Form U4 was a violation of NASD Rule 2110. *Dep't of Enforcement v. Mathis*, Complaint No. C10040052, 2008 FINRA Discip. LEXIS 49, at *13-14 (FINRA NAC Dec. 12, 2008) (finding that a "Form U4 that is inaccurate or incomplete so as to be misleading may be deemed to be conduct inconsistent with just and equitable principles of trade in violation of NASD Rule 2110"), *aff'd*, Exchange Act Rel. No. 61120, 2009 SEC LEXIS 4376 (Dec. 7, 2009), *appeal filed*, No. 10-4290-ag (2d Cir. Feb. 3, 2010); *see* IM-1000-1.

Cody conceded that he was required to disclose the settlements on Form U4, but argues that he had valid excuses that justified his two-year delay. Specifically, Cody testified that Leerink's compliance officer, Peter Flynn ("Flynn"), advised him that he had no reporting obligation because the settlements would describe the customers' claims as "based upon performance and not any specific client complaint." Flynn's purported advice, however, flew in the face of the plain language of Question 14I(1), which made the reporting requirement dependent on the complaint's allegations, not on how the settlement agreement couched those allegations. As another excuse, Cody testified that he assumed that GunnAllen, which Cody made aware of the settlements as early as November 2005, would do "whatever was necessary" with respect to his Form U4, and that he did not realize until early 2006 that GunnAllen had not updated his form. Cody's attempt to shift the blame to GunnAllen fails. The "obligation to keep the Form U4 current falls squarely on the registered representative." *Mathis*, 2008 FINRA Discip. LEXIS 49, at *16 (citing *Frank R. Rubba*, 53 S.E.C. 670, 674 (1998)).

Accordingly, we affirm the Hearing Panel's finding that Cody failed to timely update his Form U4, in violation of NASD Rule 2110.

VIII. Sanctions

A. Unsuitable Recommendations

For Cody's unsuitable recommendations, the Hearing Panel imposed a three-month suspension and a $20,000 fine. A stronger sanction is needed to remedy Cody's violations. As explained below, we impose a one-year suspension and a $20,000 fine.

For unsuitable recommendations, the FINRA Sanction Guidelines ("Guidelines") recommend that we impose a fine between $2,500 and $75,000, that we suspend a respondent in any or all capacities for a period of 10 business days to one year, and that, in egregious cases, we consider a longer suspension (of up to two years) or a bar.[33] In assessing the appropriate sanctions, we also consider the Guidelines' Principal Considerations in Determining Sanctions.

There are several aggravating factors. Cody's suitability violations occurred over 15 months and amounted to a pattern of misconduct over an extended period of time.[34] Cody's qualitatively unsuitable recommendations—i.e., the recommended ABSs and non-investment grade bonds—were, while few in number, significant in size.[35] Cody's unsuitable recommendations generated commissions for him.[36] Moreover, JB's and the Ds' level of sophistication was low, at least when it came to bond trading and active trading.[37]

We also find that Cody attempted to conceal his suitability violations from his customers.[38] According to EB, when the Bs noticed in June 2003 that the value of the ABS had decreased, Cody told JB "not to worry" because it did not concern "his particular bond." In November 2003, when LD expressed concern about a letter she received from the Firm requesting that she acknowledge certain risks involved with her "collateralized mortgage obligation" investment, Cody minimized the letter as "just a formality" and told LD, "[d]on't worry about it" and "[e]verything is safe." In late 2003, when LD questioned Cody about the trading activity in her IRA, Cody told her, "[d]on't worry about it. It is going to work out." In 2004, when JB received confirmation that his ABS was sold, Cody falsely told JB that he had not lost money because the difference between the purchase and selling prices would be reimbursed over time. Similarly, Cody told LD that the Ds' losses on the ABS would be "reimbursed." It is also troubling that Cody omitted to disclose to LD and the Bs that they would be paying mark-ups and mark-downs on bond transactions.

Furthermore, Cody's excessive trading resulted from recklessness.[39] Cody must have known that his active trading of JB's and LD's retirement accounts was unsuitably excessive,

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33 *FINRA Sanction Guidelines* 99 (2007), http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf [hereinafter *Guidelines*].

34 *Id.* at 6 (Principal Considerations in Determining Sanctions, Nos. 8, 9).

35 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 18).

36 *Id.* (Principal Considerations in Determining Sanctions, No. 17).

37 *Id.* (Principal Considerations in Determining Sanctions, No. 19).

38 *Id.* at 6 (Principal Consideration in Determining Sanctions, No. 10).

39 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

given the obvious need to trade the accounts in a manner that preserved capital. Cody also was reckless in concentrating a significant percentage of JB's account in three non-investment grade bonds. Cody knew that JB sought only low risk.[40]

Considering all the facts and circumstances, we find that the Hearing Panel's sanctions are not strong enough to remedy Cody's suitability violations. Accordingly, for Cody's unsuitable recommendations, we impose on Cody a one-year suspension in all capacities and a $20,000 fine.[41]

B. Misleading Account Summaries

For Cody's sending of misleading account summaries, the Hearing Panel fined Cody $5,000. As explained below, we affirm that sanction.

Although the Hearing Panel consulted the Guidelines for misrepresentations, our practice in false account statements/account summaries cases is to consult the Guidelines for falsification of records. *See Dunbar*, 2008 FINRA Discip. LEXIS 18, at *34; *Dep't of Enforcement v. Bendetsen*, Complaint No. C01020025, 2004 NASD Discip. LEXIS 13, at *19 (NASD NAC Aug. 9, 2004). For such violations, the Guidelines recommend a fine of $5,000 to $100,000, a suspension for up to two years in cases where mitigating factors exist, and a bar in egregious cases.[42]

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40 In contrast, we find that Cody's recommendation of the ABSs resulted from negligence, especially considering that he based that recommendation in part on the fact that the tranche carried an investment grade rating. Cody claims it is further mitigating that he recommended the ABSs in reliance on the Firm's fixed income specialist, Skelley. A representative, however, cannot shift his independent responsibility to assess the suitability of a recommendation to another representative or his Firm. *Stephen Thorlief Rangen*, 52 S.E.C. 1304, 1308-09 (1997). As explained above, in consulting with Skelley, Cody did not actively obtain sufficient information to provide him with a fundamental understanding of the ABS, its structure, and its essential risks.

41 Cody claims that it is also mitigating that he has no disciplinary history, and that he provided substantial assistance to FINRA. The absence of a disciplinary history, however, is not mitigating, and the record does not show that Cody provided FINRA with any more assistance than he was required to. *See Philippe N. Keyes*, Exchange Act Rel. No. 54723, 2006 SEC LEXIS 2631, at *23 & nn.20, 22 (Nov. 8, 2006) (finding cooperation during FINRA investigation and a lack of disciplinary history not mitigating). Nor is it mitigating that Cody paid to the customers restitution of their losses incurred on the ABSs. The Guidelines direct that we consider whether respondent "voluntarily and reasonably attempted, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct." Cody paid restitution only after the customers complained to the Firm.

42 *Guidelines*, at 39.

There are a number of aggravating factors. The nature of the documents that Cody falsified is aggravating.[43] In this regard, the misleading ladders were akin to account statements, which we have found to be critically important documents. *Dunbar*, 2008 FINRA Discip. LEXIS 18, at *34-35. Moreover, the ladders were important to the customers, because Cody provided the ladders in response to the customers expressing that they had difficulty understanding their account statements. The number, size, and character of the misleading ladders that Cody sent over an 11-month period also are aggravating, and reflected a pattern of misconduct over an extended period.[44] Furthermore, the correspondence was not just misleading, but materially misleading. In this regard, the overstatements of the "total" account or portfolio values were substantial. Likewise, the Bs would have considered it important that their EDS bonds had been sold pursuant to Cody's exercise of discretion, rather than due to a call, because the Bs were exploring why they had realized certain losses.

We agree with the Hearing Panel, however, that Cody's sending of the misleading account summaries was neither an intentional act, nor the result of recklessness. There was no allegation that the initial ladders Cody sent contained misleading total portfolio values. Rather, Enforcement alleged that the ladders became misleading only when Cody added additional content concerning the customers' non-fixed income investments without changing the nature of the content that he included for the fixed income investments. In addition, we find it significant that Cody began sending the ladders not on his own initiative, but in response to the customers' request for information. Furthermore, Cody corrected the misleading ladders, prior to detection and intervention by the Firm, by adding information about the market values of the customers' bonds.[45] Such facts suggest that to the extent the ladders presented misleading "total" values, it was not because Cody intended to mislead. Nonetheless, considering the degree to which the account summaries were misleading, the period of time over which he sent them, and the customers' lack of sophistication, we find that Cody's sending of those account summaries was not just negligent, but grossly negligent.

As for Cody's state of mind concerning the errors on EB's ladders, such errors resulted from simple negligence. Considering that EB's ladders contained a considerable amount of detailed information, the few isolated errors appear to be mistakes. Likewise, we find that there is no evidence to suggest that Cody's sending of the misleading account activity sheets resulted from anything more than negligence. Enforcement did not question Cody about why he had indicated that the EDS bonds were called, and the record lacks other evidence that Cody must have known that that aspect of the account activity sheets was misleading.

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[43] *Id.* (Principal Considerations in Determining Sanctions, No. 1).

[44] *Guidelines*, at 6-7 (Principal Considerations in Determining Sanctions, Nos. 8, 9, 18).

[45] *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 3).

Cody argues that it is mitigating that Mazza had approved his use of the ladders. While the preponderance of the evidence does not support Enforcement's allegations that Cody acted in violation of the Firm's correspondence approval policies, neither does it support Cody's opposite contention that he obtained approval. But regardless, Cody should have known that the "totals" on the ladders were misleading, especially considering the number of misleading ladders and that his customers lacked sophistication in bond trading.

Considering all the circumstances, Cody's sending of misleading summaries was serious, but not egregious. A sanction that ensures that Cody brings a more careful eye when sending critically important correspondence to customers is warranted. In light of the substantial sanctions that we have imposed for Cody's suitability violations, however, a sanction higher than what the Hearing Panel has imposed will not serve much more of a remedial purpose. Accordingly, we impose a $5,000 fine on Cody for his misleading summaries.

C. Form U4 Violations

The Hearing Panel fined Cody $2,500 for failing to update his Form U4 in a timely manner. We affirm.

Form U4 is used by FINRA and other self-regulatory organizations "to determine the fitness of applicants for registration as securities professionals," and "the candor and forthrightness of applicants is critical to the effectiveness of the screening process." *Guang Lu*, Exchange Act Rel. No. 51047, 2005 SEC LEXIS 117, at *19-20 (Jan. 14, 2005), *aff'd*, 179 Fed. App'x 702 (D.C. Cir. 2006). For an individual's late amendments to Form U4, the Guidelines recommend a fine between $2,500 and $25,000. The Guidelines do not specify a range of suspensions for late amendments, except in egregious cases where they recommend a suspension of up to two years or a bar.[46]

There are several aggravating factors. The nature of the information that Cody failed to report was material. Among other things, disclosing the settlements would have allowed investors to assess whether such settlements affected their confidence in him. *See Mathis*, 2009 SEC LEXIS 4376, at *28-29 (holding that undisclosed tax liens were material information); *Dep't of Enforcement v. Knight*, Complaint No. C10020060, 2004 NASD Discip. LEXIS 5, at *13 (NASD NAC Apr. 27, 2004) ("[W]e presume that essentially all the information that is reportable on the Form U4 is material."). Cody's misconduct left his Form U4 misleading for a two-year period, an extended period of time.[47] Moreover, Cody's failure to update his Form U4 was reckless. Although Cody "assumed" his member firm would update the Form U4 with information about the August /September 2005 settlements, Cody was aware early on that it had not done so. In his April 2006 on-the-record interview, Cody testified that he knew as early as January 2006 that his Form U4 did not disclose the settlements, and that very interview reminded

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46 *Guidelines*, at 73.

47 *Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 9).

him again of that fact. Likewise, in approximately September 2006, Cody's lawyer told him he needed to update his Form U4. Nevertheless, it was not until one year later that Cody's Form U4 was finally updated.

That Cody finally pressed GunnAllen to update his Form U4 in September 2006 when his counsel advised him to do so, and that GunnAllen may then have reacted dilatorily, are not mitigating factors. Such facts do not show that Cody had a good faith basis for failing to update the Form U4 when he was required to do so. What they *do* show is that Cody did not begin to press GunnAllen until nearly one year after he was first required to update the Form U4, and that it took another year until his Form U4 was updated. Cody's actions in following up with his firm to ensure that his Form U4 had been properly amended were too late and without the necessary level of urgency.

While we think this is a serious violation, several factors cause us to conclude that it is not egregious. Cody was not statutorily disqualified as a result of the settlements, and his conduct did not result in any harm to a registered person, member firm, or any other person or entity.[48] In addition, there was no evidence that Cody attempted to conceal his Form U4 violation, especially considering that GunnAllen was evidently aware of the settlements soon after they were executed.[49]

Considering all these circumstances, a $2,500 fine is sufficient to ensure that Cody understands the importance of complying with his Form U4 obligations. Accordingly, we impose a $2,500 fine for Cody's failure to update his Form U4.

D. Restitution Is Not Appropriate

Enforcement appeals the Hearing Panel's refusal to award restitution. The NAC recently concluded that, as a matter of sanctions policy, it will not order restitution where a customer has voluntarily entered into a settlement that releases a respondent from further liability, absent evidence that such settlements were procured by fraud. *Dep't of Enforcement v. Kaweske*, Complaint No. C07040042, 2007 NASD Discip. LEXIS 5, at *53-55 (NASD NAC Feb. 12, 2007). As explained above, the customers all settled with Cody. In those settlements, the customers released Cody from further liability. There is no evidence that such settlements were procured by fraud. In accordance with *Kaweske*, we decline to order restitution.

IX. Conclusion

We affirm the Hearing Panel's findings that Cody made quantitatively and qualitatively unsuitable recommendations, sent misleading account summaries, and failed to update his Form U4. For the suitability violations, we suspend Cody for one year in all capacities, and fine him

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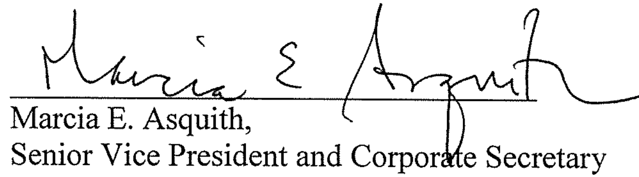
[48] *Id.* at 73 (Principal Considerations in Determining Sanctions, Nos. 2, 3).

[49] *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 10).

$20,000. For the misleading account summary violations, we fine Cody $5,000. For the Form U4 violations, we fine Cody $2,500. Finally, we affirm the requirement that Cody pay hearing costs of $7,087.50, and we impose appeal costs of $1,623.75.[50]

On Behalf of the National Adjudicatory Council,



Marcia E. Asquith,
Senior Vice President and Corporate Secretary

50 We also have considered and reject without discussion all other arguments advanced by respondent.

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