NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C8A990081
v.	:	
	:	**Hearing Panel Decision**
JAMES B. CHASE (CRD #368743),	:	Hearing Officer - GAC
Milwaukee, WI	:	
	:	September 25, 2000
Respondent.	:	

Digest

The Department of Enforcement ("Enforcement") filed a one cause Complaint alleging that Respondent James B. Chase ("Respondent" or "Chase") violated NASD Conduct Rules 2110 and 2310 by recommending and effecting transactions in customer YH's account without a reasonable basis for believing that such recommendations were suitable for YH. The transactions were alleged to be unsuitable due to the nature of the securities, the concentration of the securities in the account, and the customer's investment objectives and financial situation and needs.

Based on the Hearing record, the Hearing Panel found that Respondent Chase violated the Rules as alleged in the Complaint. The Hearing Panel suspended Respondent Chase in all capacities for six months, fined him $25,000 and ordered that he requalify through examination for the Series 7, General Securities Representative license.

Appearances

Dale A. Glanzman, Esq. (Rory C. Flynn, Washington, DC, Of Counsel), on behalf of the Department of Enforcement.

Michael J. Koenigsnecht, Esq., on behalf of the Respondent.

DECISION

I. PROCEDURAL BACKGROUND

A. Complaint

Enforcement filed a single cause Complaint on December 7, 1999, charging the Respondent with violating NASD Conduct Rules 2110 and 2310. The Complaint alleged that from December 1995 through February 1997, Respondent Chase recommended and effected approximately 102 purchases of common stock in the Female Health Company ("FHC") for the accounts of YH, a public customer. According to the Complaint, Chase engaged in such activities without having a reasonable basis for believing that the recommendations were suitable for YH, based upon the facts known to the Respondent. Specifically, it alleges that the nature of the securities and the undue concentration of securities in YH's account were unsuitable, given YH's investment objectives, financial situation and needs.

B. Answer

The Respondent filed an Answer on January 6, 2000, in which he requested a Hearing and stated that he was unable to obtain sufficient information to admit or deny the allegations in the Complaint.

C. The Hearing

The Hearing was held in Chicago, Illinois, on June 6, 2000, before a Hearing Panel composed of the Hearing Officer, and two current members of the District 8 Committee. Enforcement presented one witness, Gary Stark ("Stark"), a Field Supervisor in NASD Regulation, Inc.'s ("NASDR") Chicago office, and also cross-examined the Respondent, who testified on his own behalf.[1]

The Hearing Officer admitted into evidence all 26 exhibits offered by Enforcement (CX 1-26) and all three exhibits offered by the Respondent (RX A-C).[2] The Parties also offered a Joint Stipulation of Facts ("Stipulation").

II. FINDINGS OF FACT

A. Background of Respondent

James B. Chase, age 55, was associated with member firm Robert W. Baird & Co., in Milwaukee, Wisconsin, from 1969 until 1991. During that time, the Respondent had varying responsibilities, including opening branch offices, working in the research department, and doing corporate and merchant banking work.[3] In 1991, the Respondent left Robert W. Baird & Co., to become registered as a General Securities Representative with Megarian, Inc. ("Megarian"). In 1994, the Respondent also became registered as a Municipal Securities Representative with Megarian.

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[1] Hearing Tr., pp. 37-38.

[2] The exhibits for both Parties were offered without objection from the opposing Party. Joint Stipulation of Facts, ¶¶ 10-11.

[3] Hearing Tr., p. 54.

In 1995, Respondent Chase became registered as a General Securities Representative and Principal with Collopy & Company, Inc. ("Collopy"), a member firm. In February 1996, the Respondent became the President, Secretary, Treasurer and sole owner of Collopy.[4] He remained with Collopy until December 1997, when he voluntarily left the firm.[5] From 1977 until 1998, Respondent Chase taught graduate and undergraduate courses in corporate finance, SEC accounting and basic investing at two universities in Wisconsin.[6] The Respondent is not currently associated with a member firm.

B. Establishment and Trading of the Customer Account

In July 1994, YH was a 24 year old single college student who shared a condominium with her mother. YH had no significant source of income and no investment experience in securities.[7] She was also receiving treatment for "long-standing depression."[8] At around that time, YH entered into a court settlement as a claimant in a sexual assault case.[9] As part of that settlement, YH received securities valued at approximately $540,000.[10] Those securities represented virtually all of YH's assets.

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[4] CX 23, p. 15.

[5] Respondent Chase also sold his interest in the firm back to John Collopy from whom he had purchased it. Hearing Tr., pp. 54-55.

[6] Hearing Tr., pp. 55-56.

[7] CX 16, p. 3. YH's tax returns for the years 1994 - 1997, show that YH had less than $1,000 in wages or salaries for each of those years. CX 7. Respondent Chase acknowledged that he was aware that YH had no prior investment history. Hearing Tr., pp 187-188.

[8] CX 16, p. 3.

[9] CX 16, pp. 2-3.

[10] The figure is before subtracting the attorney's fees, representing 20 percent of the gross amount of the settlement. RX B.

In 1994, following the court settlement, YH's attorney in that civil matter referred her to the Respondent to manage or invest her assets.[11] The Respondent met with YH and her counsel several times before opening the account.[12] At that time, YH and her counsel informed Respondent Chase that her investment objectives were income and safety of the principal.[13]

The Respondent admitted at the Hearing to understanding those objectives.[14] The new account form used to open YH's account at Megarian in September 1994 also reflects these investment objectives as "income" and that she preferred "low" risk exposure.[15] The new account was a cash account and correctly listed YH's "[years] of investment experience" as "zero."[16]

From the opening of the account, through January 1995, the account maintained a relatively balanced portfolio of asset backed securities, US Treasury securities, other US government bonds, corporate bonds, equity securities, and limited partnerships.[17] During this time period, YH withdrew approximately $17,000 from the account for personal expenses. The Respondent believed, based on the size and frequency of these withdrawals, that it was not

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[11] At the time of the referral, Respondent Chase had been the "personal advisor" for YH's attorney for "many years." RX B.

[12] Hearing Tr., p. 61.

[13] Hearing Tr., p. 63; CX 16, p. 1.

[14] Hearing Tr., pp. 63, 101, 103.

[15] CX 16, p. 5. The information on the new account form is consistent with the customer's affidavit in with the customer states that the account "was limited to managing the account to preserve assets and to provide income." (CX 16, p.1)

[16] CX 16, p. 5; Hearing Tr. p. 63.

[17] CX 10.

advisable to invest in bonds or preferred securities, given that, "the spreads [in these securities] were greater … [and that] you couldn't just keep going in and out."[18]

The Respondent claims that at some point, he discussed the account's objectives with YH and her attorney. According to the Respondent, he explained that either YH would have to stop withdrawing money from the account, or they would have to change the objective of the account.[19] The Respondent stated that it was necessary to change the investment objectives since "there was no way that the account which was set up to give her an income stream could match the withdrawals on the account."[20] Respondent testified that based on that conversation, he believed that YH agreed to change her primary investment objective to "growth."[21]

The Hearing Panel finds that YH never changed her investment objectives and that the Respondent improperly and unnecessarily tried to force the customer to choose between withdrawing funds from her account and changing her investment objectives. Although Respondent Chase may have had a good faith reason to believe that YH's current investments would not satisfy her investment objectives given her rate of withdrawals from the account, it did not obligate the customer to change her investment objectives. YH continued to value the safety of the principal that remained in the account and continued to require that it produce income, given her own lack of other forms of income. The Respondent should have continued to work

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[18] Hearing Tr., p. 64.

[19] Hearing Tr., pp. 64-66.

[20] Hearing Tr., p. 64.

[21] Hearing Tr., pp. 65-66.

with the funds remaining in the account in a manner consistent with the customer's unchanged objectives.

In a sworn affidavit, YH stated that at no time during February 1995 through February 1997, did she agree to change her investment objectives from "preserve assets and provide income."[22] After a review of the evidence, the Hearing Panel finds YH's affidavit to be the more credible evidence as to YH's investment objectives and therefore finds that YH never agreed to change her investment objectives. This finding is consistent with a finding that the customer's financial needs to preserve the principal and secure income had not changed.

Even if the Respondent had a good faith reason for changing YH's investment objectives, the Hearing Panel finds that the Respondent provided unsuitable recommendations even under those revised investment objectives. The Hearing Panel finds that the most serious violations were the undue concentration of securities in YH's account and the inappropriate use of the margin account, as described more fully below.

C. YH's Purchases of the Female Health Company

After the Respondent considered YH's objectives to have changed, he recommended a number of local companies to her. In or about February 1995, Respondent Chase recommended that YH purchase the securities of the Female Health Company ("FHC").[23] In 1995, FHC was a start-up company, whose business consisted of the manufacturing and sale of

[22] CX 16, ¶ 5.

[23] Hearing Tr., pp. 97-98, 103.

a single product, the female condom.[24] Respondent Chase acknowledged that in 1995 and 1996, FHC was a speculative investment.[25]

During the years 1993 through 1995, while its net revenues increased from approximately $25,000 to $2.2 million, its net loss also rose from $3.7 million to $8.3 million.[26] A Prospectus for the company dated June 18, 1996, stated under its "Risk Factors," that "[i]f sales do not significantly increase, the Company will continue to report operating losses and, ultimately, the Company's viability may be in jeopardy."[27] The Prospectus discussed the net losses and indicated that there could "be no assurance that the Company will achieve a profitable level of operations in the future."[28]

Respondent Chase's interest in FHC went beyond merely recommending the security to retail customers. On or before February 1996, FHC retained Respondent Chase to find a buyer for 450,000 shares of the issuer that a director of the company wanted to sell.[29] By April 9, 1996, he had found a buyer, thereby earning a "finder's fee" of 60,000 shares of FHC.[30] In April 1996, the Respondent was also seeking to raise $5,000,000 in funding for FHC, for which his firm would have been compensated with an additional 50,000 shares.[31] The

[24] CX 4, p. 3.

[25] Hearing Tr., p. 115.

[26] CX 4, p. 6.

[27] CX 4, p. 8.

[28] CX 4, p. 11.

[29] Hearing Tr., pp. 77-78, 88.

[30] CX 19.

[31] CX 19.

Respondent also assisted or attempted to assist one or two other placements of FHC securities on behalf of shareholders.[32] According to the Respondent, he recommended FHC to all of his clients who purchased equity securities.[33]

YH made her first purchase of FHC based on the Respondent's recommendation, in February 1995. Respondent Chase recommended to YH that she continue to purchase the security. As a result, by the end of June 1995, YH owned more than 15,000 shares of FHC, representing approximately 12 percent of her portfolio assets.

On May 30, 1995, Respondent Chase became associated Collopy and in June 1995, had YH's account transferred to Collopy.[34] The Respondent became registered as a General Securities Representative with Collopy on July 21, 1995.[35] The Respondent continued to recommend that YH purchase FHC through the balance of 1995, despite the growing concentration of the security in her account. The concentration of the security grew steadily in YH's account through 1995, increasing to 52 percent of the account's value by year-end. Despite having more than half of her assets invested in this single speculative security, Respondent Chase continued to recommend that YH purchase additional FHC.

YH continued to purchase FHC in 1996 at the recommendation of the Respondent. She continued to sell her other securities in order to pay for the FHC purchases. In March

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[32] Hearing Tr., pp. 136-137.

[33] Hearing Tr., p. 98.

[34] CX 8, p. 2. John Collopy was initially listed as the registered representative for the account, presumably until the Respondent became properly registered at Collopy.

[35] CX 1, p. 5.

1996, Respondent Chase prepared another new account form for YH.[36] That form listed her net worth as $800,000, her liquid assets as $500,000 and her annual income as "30%."[37] It also listed her investment objectives in order of priority as growth first, speculation second, income third and safety fourth.[38] YH never saw the form that reclassified her investment objectives and never agreed to it.[39]

D. The Margin Account

In May 1996, YH's portfolio already contained more than 63,000 shares of FHC, representing more than 88 percent of her portfolio assets. At that time, Respondent Chase encouraged YH to change her account from a cash account to a margin account in order to allow her to acquire more shares of FHC.[40] In a letter to YH dated May 13, 1996, Respondent Chase thanked YH for having come into the office to sign the margin agreement and noted "[a]s I mentioned we will use the borrowed funds to hold the larger FHC position. Paine Webber charges 8.375% on its margin accounts. We believe the potential gain on the position justifies this increased cost."[41] In his discussions with YH about setting up the margin account, the Respondent stated that he discussed the risks and the rewards of a margin account, but never discouraged her from opening the account.[42] In fact, the correspondence clearly

[36] CX 8, p. 4.

[37] CX 8, p. 4.

[38] CX 8, p. 6.

[39] CX 16.

[40] Hearing Tr., pp. 128, 130.

[41] CX 12.

[42] Hearing Tr., pp. 130-132.

shows that the Respondent encouraged YH to open the margin account in order to acquire more FHC.

Based on the Respondent's continued recommendations, by the end of May 1996, YH's account had accumulated a total of 101,000 shares of FHC, representing 100 percent of her asset portfolio.[43] YH was able to acquire the additional shares of FHC by selling off the balance of the non-FHC securities in her portfolio and using the additional buying power created by converting to a margin account.[44] As a result of purchasing on margin, there was a loan balance of more than $217,000 created in the account in just one month.[45] Between June and December 1996, YH's month-end margin balance ranged from $43,000 to more than $195,000, causing interest payments of more than $9,500 for those months.[46]

During the balance of 1996, through February 1997, YH's account continued to maintain a 100 percent concentration in FHC, with month-end balances ranging from a high of 131,100 shares in July 1996, to a low of 64,000 shares in February 1997. The reduction of FHC in the account in early 1997 came as a result of a decline in the share price of FHC, from more than $5.00 per share in October 1996, to less than $3.00 per share in February 1997. This drop in value caused the selling of FHC securities to cover margin calls in the account. By the end of February 1997, the value of the FHC securities in YH's account was approximately $188,000 and the account maintained a margin balance of nearly $84,000.

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[43] Hearing Tr., p. 103.

[44] CX 10, p. 209.

[45] CX 10, pp. 206-211.

[46] CX 10, pp. 209-235.

E. The Respondent's Position on Diversification

Despite accumulating a 100 percent concentration of a single, speculative security in YH's account, the Respondent never instructed YH that he thought she needed to diversify her portfolio. According to Respondent Chase, he did have several conversations with YH, in which "we talked about the upside and also talked about the downside" of having 100 percent of her portfolio in FHC.[47] At the Hearing, the Respondent testified:[48]

> Q. Did you recommend to her that she not have a 100 percent concentration of her portfolio in Female Health Company?
>
> A. No, I did not recommend that.
>
> Q. Did you urge her at any time to reduce the concentration?
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> A. We talked about it, and I asked her what she wanted to do.
>
> Q. [D]o you recall recommending to her that she diversify her portfolio and not have 100 percent …
>
> A. No….
>
> Q. Were you comfortable that she was – that she had 100 percent of her portfolio in Female Health Company?
>
> A. I was not as comfortable with it as she was.

Respondent Chase's failure to advise YH to diversity her account is consistent with his own investment strategy, as he explained at the Hearing:

> I think it's been proven that having a portfolio of just a few stocks is not necessarily a bad idea. I don't buy the argument that if you have one or two stocks that that's bad and instead you should have an index of a corporate portfolio. I've done enough studies on that. It doesn't work. You can make

[47] Hearing Tr., p. 125.

[48] Hearing Tr., pp. 126-127.

> more money on the one or two stocks than on a broader one in a lot of cases. I'm not saying that's wrong to have only one or two stocks. There's enough evidence out there that would back me up on that, but that isn't wrong per se.[49]

Given the Respondent's own investing philosophy involving large concentrations of securities, and his discussion with YH about having all of her assets in a single, speculative security, the Hearing Panel finds that the Respondent did not provide adequate advice about the risks inherent in such investments. The Respondent has a clear misunderstanding of his own obligations, as the securities professional, to advise his clients. Instead of providing the advice himself, Respondent Chase explained that YH "had advisors" to discuss the investment decisions with, including her attorney, her mother and her mother's friend.[50]

III. LEGAL DISCUSSION

Rule 2310(a) provides that:

> In 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.

Implicit in this Rule is the "fundamental responsibility for fair dealing" that a registered representative has with his customers.[51] "Compliance with the rule requires the representative to 'make a customer-specific determination of suitability and … tailor his recommendations to the customer's financial profile and investment objectives.'"[52] According to the SEC,

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[49] Hearing Tr., pp. 193-194.

[50] Hearing Tr., p. 131-132, 194.

[51] In re Larry Ira Klein, Exchange Act Rel. No. 37835 (October 17, 1996), *citing* John M. Reynolds, 50 S.E.C. 805, 809 n. 13 (1991).

[52] In re Larry Ira Klein, *supra*, *quoting* F.J. Kaufman & Co. of Va., Exchange Act Rel. No. 27535, 50 S.E.C. 164, 168 (December 13, 1989).

> a broker may violate the suitability rule if he fails so fundamentally to comprehend the consequences of his own recommendation that the recommendation is unsuitable for any investor, regardless of the investor's wealth, willingness to bear risk, age, or other individual characteristics.[53]

In this case, the Hearing Panel finds that the concentration of investments in one speculative security was inherently unsuitable for customer YH, no matter what her investment objectives. The recommendations were particularly unsuitable given her investment objectives of income and safety of principal.

The SEC has previously held registered representatives liable for recommending transactions that failed to account for the need for sufficient diversity in customer accounts. In Stephen Thorlief Rangen, the Commission found an undue concentration of securities where 80 percent of the equity in the customer's account was concentrated in one security. There, the SEC stated that "by concentrating so much of their equity in particular securities, [the registered representative] increased the risk of loss for [the customers] beyond what is consistent with the objective of safe, non-speculative investing." Exchange Act Rel. No. 38486; p. 5; 1997 SEC Lexis 762; 54 S.E.C. 1304 (April 8, 1997).

This case, like Rangen, involves a broker handling all or virtually all of the customer's net worth. In Rangen, the respondent contended that he was not liable since the customers were "aware of the risks and it would have been wrong for him to refuse their orders merely because he felt that the investments were not suitable." *Id*. The SEC rejected that notion, stating that even if the "clients wanted to speculate and were aware of the risks … the Commission has held on many occasions that the test is not whether [the retail customers] considered the transactions in their account suitable, but whether [the registered representative] 'fulfilled the obligation he assumed when he undertook to counsel [them], of making only such recommendations as would be consistent with [their] financial situation and needs.'"[54]

The Hearing Panel also found that since virtually all of the customer's assets were already invested in FHC, the Respondent engaged in unsuitable recommendations when he had YH open a margin account to further extend her investments in FHC. The SEC has noted the inappropriateness of using a margin account in some cases, stating

> Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently, giving rise to a margin call in the account. Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain. At the same time, using margin permitted the customers to purchase greater amounts of securities, thereby generating increased commissions for [the registered representative]. Rangen, *supra* Exchange Act Rel. No. 38486; p. 5; (April 8, 1997).

In finding that a registered representative improperly employed a margin account for a customer, the SEC noted that,

> The amount of liquid assets is particularly relevant to margin purchasers … because, if a margin purchaser does not have sufficient liquid assets to meet a margin call, the security will be sold to meet the margin call, usually resulting in a loss to the customer.[55]

In this case, the Respondent was aware that YH's investments in FHC represented virtually all of her liquid assets, and that any drop in price of FHC would trigger a margin call

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[53] Kaufman, *supra*.

[54] Rangen, *supra*, at pp. 5-6, *quoting* Eugene J. Erdos, 47 S.E.C. at 989, citing Phillips & Company, 37 S.E.C. 66, 70 (1956). *See also* Clinton Hughs Holland, Jr., Exchange Act Rel. No. 36621 (December 21, 1995), 60 SEC Docket 2935, 2941, aff'd, No. 96-70084 (9th Cir. 1997)(unpublished opinion) where there was a finding of a violation of the NASD suitability rule even though the client understood the risks because the salesperson failed to make reasonable recommendations.

[55] Kaufman, *supra*, at n. 25.

that could not be met without the sale of securities in the account. He was also aware, given her lack of outside income, that she would need to pay for the margin interest generated in the account through the sale of FHC securities. Respondent knew all of the facts necessary to see that there were no reasonable grounds for recommending the purchase of FHC at such concentrated levels under any circumstances. This was particularly so where the stated investment objectives of the customer were income and safety of principal.

By reason of the foregoing, the Hearing Panel finds that Respondent Chase engaged in unsuitable recommendations to customer YH by providing improper advice to change her investment objectives, by recommending FHC at undue levels of concentration, and by recommending the use of a margin account to the extent utilized by customer YH. Respondent's behavior violated NASD Conduct Rules 2110 and 2310 as alleged in the Complaint.

IV. SANCTIONS

The NASD Sanction Guideline for suitability violations states that "[i]n cases involving recommendations of clearly unsuitable securities and no prior similar misconduct," adjudicators should consider suspending an individual respondent in any and all capacities for 10 to 30 business days and, in egregious cases, a longer suspension (of up to two years) or a bar should be considered. The Guideline also suggests the imposition of a fine ranging between $2,500 and $50,000, and that "[a]djudicators should increase the . . . fine amount by adding the amount of a respondent's financial benefit," which may "include the amount of any commissions or other profits that the respondent derived from the unsuitable trading."[56] Enforcement requested that Respondent Chase be suspended for six months, and fined $25,000.

In determining the appropriate sanctions, the Hearing Panel considered the principal considerations outlined in the NASD Sanction Guidelines. Among the considerations was the Respondent's prior disciplinary history. Included in Respondent Chase's disciplinary history is a 1991 censure by the State of Wisconsin for making unsuitable recommendations to a customer, involving a security whose issuer had filed for bankruptcy.[57] The Respondent was also censured in 1995 by the New York Stock Exchange for having effected unsuitable transactions in the account of a customer.[58]

The Hearing Panel finds that the Respondent engaged in this unsuitable trading over a two year period. During that time, the Respondent effected approximately 100 transactions in FHC in the customer account. Once it was clear that Respondent's actions of opening a margin account and further extending the customer's undue concentration were wrong, the Respondent did not voluntarily attempt to remedy the misconduct, but waited for the customer to file an arbitration claim against him. It was only then that the Respondent agreed to settle that claim.

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[56] NASD Sanction Guidelines 83 (1998 ed.). Enforcement presented no evidence as to the commissions earned by the Respondent based on these unsuitable recommendations. The customer, YH, was compensated for her losses as a result of actions brought through arbitration.

[57] CX 22, p. 2.

[58] CX 23, p. 18; CX 24.

In doing so, the Respondent still did not acknowledge his wrongdoing, but simply explained the settlement as making more financial sense than litigating the claim.

Based on a review of its findings and the principal considerations, as described above, the Hearing Panel believes that this is an egregious violation. As described above, the Hearing Panel also believes that the Respondent lacks a fundamental understanding of his obligations toward his retail clients. The Hearing Panel therefore suspends the Respondent in all capacities for six months, fines the Respondent $25,000, and orders that he requalify for the Series 7 examination within six months of the date of decision or cease operating in that capacity until he so requalifies.

IV. CONCLUSION

The Hearing Panel found that Respondent Chase violated NASD Rules 2110 and 2310 as alleged in the Complaint. The Hearing Panel suspended the Respondent in all capacities for six months, fined the Respondent $25,000, and ordered that he requalify for the Series 7 examination within six months of the date of decision or cease operating in that capacity until he so requalifies. The Hearing Panel also assessed joint and several costs against the Respondents in the amount of $2,243.40, consisting of a $750.00 administrative fee and $1,493.40 for the cost of the Hearing transcript.[59] These sanctions shall become effective on a date set by the Association , but not earlier than 30 days after this decision becomes the final disciplinary action of the Association, except that if this decision becomes the final disciplinary action of the

[59] The Hearing Panel considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.

Association, the suspension shall become effective with the opening of business on Monday, November 20, 2000, and end on Sunday, May 20, 2001.

Hearing Panel

by: ____________________
Gary A. Carleton
Hearing Officer

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