BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of Complainant 1, vs. Respondent Firm 1, and Respondent 2, Respondents.	DECISION Complaint No. C07950030 District No. 7 (ATL) Dated: November 24, 1997

This matter arises from a complaint filed by Complainant 1 naming as respondents Respondent Firm 1 and Respondent 2. The District Business Conduct Committee for District No. 7 ("DBCC") held a hearing and dismissed the complaint in a decision dated March 15, 1996. Complainant 1 filed this appeal pursuant to Article III, Section 1 of the NASD's Code of Procedure (now Procedural Rule 9310). We affirm the DBCC's dismissal.

Background

Respondent Firm 1 has been a member firm since December 1936. Its principal place of business is in New York, and it maintains a branch office in Georgia.

Respondent 2 entered the securities industry in 1991, when he became registered as a general securities representative with Respondent Firm 1. He left Respondent Firm 1 in November 1991 and was associated Firm A and Firm B before returning to Respondent Firm 1 in November 1992. He was employed in Respondent Firm 1's Georgia office between November 1992 and January 1995. Respondent 2 was associated with Firm C in Texas from January 1995 until April 1996, and he has been associated with Firm D in Texas since April 1996.

Summary of DBCC and NBCC Subcommittee Proceedings

This matter was initiated by Complainant 1, a complaining customer. At the time this matter arose, Article IV, Section 2 of the NASD's Rules of Fair Practice (later Procedural Rule 8120) permitted third parties to initiate disciplinary proceedings.[1] Complainant 1 filed the complaint in this matter on May 1, 1995, and the matter was heard before a DBCC hearing panel on November 16, 1995. As explained more fully below, the DBCC dismissed the complaint in its entirety and denied the respondents' request that costs be assessed against Complainant 1.

Complainant 1 then appealed to the National Business Conduct Committee ("NBCC"), and an appeal hearing was held on October 8, 1996, before an NBCC subcommittee ("the Subcommittee"). At the hearing, Complainant 1, who is an attorney, participated, as well as counsel for Respondent Firm 1, counsel for Respondent 2, and regional counsel for District No. 7.

In an Order dated January 29, 1997, we asked the DBCC to clarify its findings with respect to certain issues relating to cause one of the complaint. In a document entitled "Order Amending Decision" issued March 6, 1997, the DBCC discussed certain of the questions raised by our January 1997 Order. By an Order dated May 23, 1997, we sought additional clarification of the DBCC's views as to cause one, specifically, whether the DBCC credited the testimony of Complainant 1 or Respondent 2 on the subject of an alleged misrepresentation of a price-to-earning ("P/E") ratio in the common stock Company A. In a 1997 decision, the DBCC credited Respondent 2's testimony that he had not misrepresented the Company A P/E in a telephone call with Complainant 1 on October 1, 1993.

---

[1] Article IV, Section 2 of the NASD's Rules of Fair Practice, entitled "Complaints by Public against Members for Violations of Rules," provided:

> Any person feeling aggrieved by any act, practice or omission of any member or any person associated with a member of the Corporation, which such person believes to be in violation of any of the Rules of Fair Practice of the Corporation, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such persons associated with a member in regard thereto with any District Business Conduct Committee of the Corporation, and any such complaint shall be handled in accordance with the Code of Procedure of the Corporation.

After a thorough review of the record and the arguments made on appeal,[2] we affirm the DBCC's dismissal of each of the causes of the complaint.

Pleadings

Complaint. The complaint contained three causes. The allegations related to Complainant 1's October 1, 1993 purchase of 1,000 shares of common stock of Company A and to the sale of the

[2] Complainant 1 sought permission to have his wife and his daughter, who is an attorney, attend the NBCC hearing. The respondents opposed Complainant 1's request, stressing that Complainant 1 had repeatedly refused to release any documentation pertaining to his wife's securities accounts because she was not a party to the proceeding. At the beginning of the NBCC hearing, after entertaining argument from the parties, the Subcommittee ruled that Complainant 1's wife would be excused from the hearing and that Complainant 1's daughter would be permitted to attend to assist him in his presentation. We ratify this ruling.

In his appeal briefs and at the NBCC hearing, Complainant 1 discussed certain evidence that was not in the record and which he had not sought permission to adduce. The respondents objected to the new evidence and offered some rebuttal evidence. We do not admit into the record any of the new evidence submitted by either side. We note that the most frequently cited piece of new evidence related to the parties' efforts to prove that the other side had initiated various attempts at settlement. For example, on the eve of the NBCC hearing, the respondents adduced a copy of a letter that Complainant 1 wrote proposing settlement, which, they asserted, conflicted with assertions that Complainant 1 made in his reply brief. We find that none of the new evidence is material and that none of it should be considered in connection with the merits. Cf. Procedural Rule 9226(i) (if an Offer of Settlement is not accepted, it should not be given consideration in the determination of the issues involved in the pending or any other proceeding).

The other proposed new evidence concerned: 1) Complainant 1's new assertion that the SEC's entry into a settlement order with the NASD demonstrated wrong-doing on the part of Respondent Firm 1; 2) Complainant 1's new assertion that Respondent Firm 1's telephone records of Respondent 2's calls to him might have been incomplete because Respondent 2 might have telephoned him at an alternative telephone number; and 3) Complainant 1's new assertion that he first discussed the stock that he bought from Respondent 2 with his Firm E broker after he had already sold the stock. We find that none of this evidence is material, and therefore none of it meets our standard for the admission of new evidence.

stock on November 30, 1993.[3] Respondent 2 solicited both transactions. Complainant 1 bought Company A at $20 3/8 and sold it at $10 1/4, losing more than $10,000 on the investment.

The first cause stated that Respondent Firm 1 and Respondent 2 violated Article III, Section 1 of the NASD's Rules of Fair Practice ("Section 1") (now Conduct Rule 2110) in that they allegedly misrepresented Company A's current P/E ratio to Complainant 1. Specifically, cause one alleged that on October 1, 1993, Respondent 2 recommended the purchase of Company A common stock; that Complainant 1 asked what the P/E ratio for Company A was; and that Respondent 2 told him that it was 24 when in fact it was 47.5. Cause one also alleged that in months prior to the transaction, Complainant 1 had repeatedly declined to purchase stocks that Respondent 2 recommended that had high P/E ratios.

The second cause alleged that Respondent Firm 1 and Respondent 2 violated Article III, Section 2 of the Rules of Fair Practice ("Section 2") (now Conduct Rule 2310) in that their recommendation to Complainant 1 to purchase Company A common stock was unsuitable based upon contemporaneous recommendations to other customers to sell. Specifically, the second cause alleged that Respondent 2 and Respondent Firm 1 recommended the purchase of Company A common stock to Complainant 1 while at or about the same time recommending that other clients sell Company A, and vice versa, without having a reasonable basis for the conflicting recommendations. The second cause alleged that shortly after Complainant 1 sold his Company A stock, two brokerage firms issued favorable recommendations about the stock and its price rose. The cause alleged that the respondents operated in their own self-interest, in violation of Section 2. The cause also alleged that because Complainant 1 had repeatedly declined to purchase high-P/E stocks, Respondent 2's recommendation of a stock with a high P/E ratio was in itself a violation of Section 2.

The third cause alleged that Respondent Firm 1 and Respondent 2 violated Section 1 and Article III, Section 14 of the Rules of Fair Practice ("Section 14") (now Conduct Rule 2250) by failing reasonably to disclose that Respondent Firm 1 had a financial interest in the transactions with Complainant 1, in that Respondent Firm 1 was the seller of the shares sold to Complainant 1 and the purchaser of the shares sold by Complainant 1. In addition, cause three alleged that the confirmations for the transactions did not provide sufficient or reasonable notice of Respondent Firm 1's interests in the transactions.

Respondent Firm 1's Answer. Under cause one, Respondent Firm 1 admitted that Respondent 2 had recommended the Company A transactions to Complainant 1. Respondent Firm 1, however, denied that Respondent 2 had misrepresented the P/E ratio. Respondent Firm 1 claimed that

[3] Company A produces high bit-rate digital subscriber line telecommunications products. Its initial public offering ("IPO") was managed by Firm E and Firm F. The public offering price was $14 per share. Public trading of the common stock commenced on September 15, 1993.

Respondent 2 had discussed with Complainant 1 not only the current P/E ratio but also the projected ratios for 1994 and 1995. Respondent Firm 1 also stated that prior to the Company A transactions, Complainant 1 had purchased two stocks with no earnings, and that on the day that Complainant 1 sold his Company A shares, he bought shares in a company with a P/E ratio much higher than Company A's.

Under cause two, Respondent Firm 1 denied that the firm or Respondent 2 had made any conflicting recommendations to customers. Respondent Firm 1 further argued, based on the net worth and investment objective listed on Complainant 1's new account form, that Company A was a suitable investment for Complainant 1.

Under cause three, Respondent Firm 1 stated that it had fully disclosed its role in the transactions on the confirmations, which indicated that the trades were principal transactions and that the firm made a market in Company A common stock. Respondent Firm 1 asserted that its confirmations met the requirements of SEC Rule 10b-10 and the NASD.

Respondent 2's Answer. Respondent 2 admitted that he had recommended the transactions to Complainant 1. Under cause one, Respondent 2 denied that he had misrepresented the P/E ratio for Company A. Respondent 2 asserted that in an initial telephone conversation on or about September 28, 1993, he had discussed with Complainant 1 a number of different aspects of the Company A investment, including the P/E ratio for 1993, as well as projected ratios for 1994 and 1995. Respondent 2 also asserted that Company A's P/E ratios had been comparable to those of other companies in the telecommunications product industry. In addition, Respondent 2 asserted that Complainant 1 had purchased shares in companies with no earnings prior to the Company A purchase and that he had bought a stock with a high P/E ratio on the day that he sold his Company A shares.

Under cause two, Respondent 2 stated that he had recommended the purchase of Company A stock to a "handful" of other customers at about the time of his initial recommendation to Complainant 1. Respondent 2 stated that when the price of fell, he contacted all of his customers who owned Company A, including Complainant 1. Respondent 2 stated that Complainant 1 declined to sell during the initial conversation and agreed to sell only later, after a further decline. Respondent 2 also asserted that no rule requires that identical advice be given to all customers.

Under cause three, Respondent 2 claimed that the confirmations had clearly disclosed that Respondent Firm 1 made a market in Company A common stock and that it acted as principal in both transactions.

In addition, Respondent 2 asserted that Complainant 1's complaint was based entirely on his desire to obtain reimbursement for his loss on the Company A investment.

Pre-Hearing Motions

The parties submitted a number of motions to the DBCC. The DBCC's decision ratified all of the DBCC hearing panel's determinations and rulings with regard to procedural and evidentiary matters. We in turn find no reason to question these rulings, and note that the DBCC took great pains to ensure that the parties were treated fairly.

Motion to Dismiss. When the respondents filed their answers, they moved to dismiss the complaint and sought monetary sanctions, attorney fees, and/or costs. The respondents argued that the complaint should be dismissed because no rule violations had occurred. In addition, Respondent Firm 1 argued that the complaint should be dismissed because the NASD should not permit the complainant to use the disciplinary process for his own benefit. Respondent Firm 1 noted that Complainant 1 had originally filed a formal complaint with the DBCC in April of 1994, and that after a staff investigation, the DBCC had declined to take action on the complaint. Respondent Firm 1 argued that the complaint that gave rise to this proceeding, which was filed in April of 1995, contained the same allegations as had the first complaint. Respondent Firm 1 argued that Complainant 1 should be required to seek redress for his perceived injuries in arbitration, in accordance with the terms of his customer agreement with the firm, and that he should not be permitted to "misuse" the disciplinary process.

Complainant 1 filed a response. He argued that he was entitled to a hearing on the complaint under the NASD's Code of Procedure. He also argued that during the NASD staff investigation, the staff did not gather and give due consideration to all of the relevant evidence in this matter, and that staff's interpretation of Section 14 was unduly narrow.[4] In addition, he asserted that the respondents should be rebuked for having requested that sanctions be awarded against him.

In a reply brief, Respondent 2 asserted that Complainant 1 should have formally appealed the DBCC's January 1995 notice that it would take no formal action. In a surreply brief, Complainant 1 asserted that he had not been required to appeal the action taken by the DBCC in January 1995. He noted that on January 16, 1995, a District No. 7 supervisor had written to him to inform him that the NASD had determined that there were insufficient grounds to warrant disciplinary action; that on January 25, 1995, he had written to the President of the NASD to complain; that on February 15, 1995, an Executive Vice President had written to him, stating that the matter would be presented to the DBCC; that on March 16, 1995, the Director of NASD District No. 7 had written to him, stating that an examination subcommittee of the DBCC had reviewed the matter and determined that no further

---

[4] In a letter dated March 31, 1995, the Director of NASD District No. 7 stated to Complainant 1 that Section 14 was inapplicable to Respondent Firm 1’s conduct in the Company A transactions because "[t]he fact that a member is a market maker and executes a transaction does not mean that the member is participating in a distribution under the federal securities laws."

action would be taken; and that on March 31, 1995, the Director had informed him that he could file a formal complaint, after which a hearing would be scheduled.

By letter dated October 24, 1995, the DBCC hearing panel determined that oral argument on the motion to dismiss was unnecessary, and the DBCC denied the motion without further discussion.

Motions for the Production of Evidence. Prior to the DBCC hearing, the parties sought the production of evidence by other parties and by NASD staff. Complainant 1 initially requested that the DBCC gather certain evidence for him. The regional attorney responded, stating that NASD staff would produce the responsive evidence from its own files, but that the DBCC would invoke its powers to compel the production of evidence by the respondents only after considering four factors: 1) whether the request was timely; 2) whether the evidence was relevant and material, and whether its probative value would outweigh the costs involved in production; 3) whether the requesting party had already made a timely and good-faith effort to obtain the information; and 4) whether the persons from whom production was sought were subject to the NASD's jurisdiction.

On July 6, 1995, Complainant 1 filed his first motion to compel the production of evidence. He noted that he had already requested certain information from Respondent Firm 1, and that Respondent Firm 1 had declined to produce: 1) an affidavit indicating whether any recordings of telephone calls between Complainant 1 and Respondent 2 had been destroyed; 2) a listing of Respondent Firm 1's solicited transactions in Company A during the 10 business days before and after each of Complainant 1's transactions; and 3) sales literature on Company A distributed by Respondent Firm 1 . On August 11, Respondent Firm 1 filed a response and asserted that the Code of Procedure did not afford a right of discovery to the complainant. Respondent Firm 1 also addressed Complainant 1's specific requests. Respondent Firm 1: 1) stated "categorically" that it had not made any recordings of telephone conversations with Complainant 1; 2) argued that the request for a listing of transactions in Company A was irrelevant, was unduly burdensome, and would compromise client confidentiality; and 3) stated that it had not distributed any reports on Company A to its employees. By letter dated October 24, 1995, the DBCC hearing panel denied the first motion. The hearing panel noted that the first item could be addressed through testimony at the hearing; that the NASD staff had already produced transaction reports for trading in Company A, and detailed customer information would be irrelevant; and that Respondent Firm 1's response on the third item was adequate.

On July 6, 1995, Complainant 1 requested additional information from District staff. On August 3, 1995, the regional attorney produced the responsive documents, except that the regional attorney, citing the confidentiality of NASD investigations and the work-product privilege, declined to produce the "entire NASD investigative file" or an index of the contents of the file. On August 11, 1995, Complainant 1 filed a second motion to compel in which he requested that District staff be ordered to produce the complete investigative file. By letter dated October 24, 1995, the DBCC granted the motion to the extent that it ordered the staff to produce all non-privileged documents in the investigative file to the parties.

On September 22, 1995, Complainant 1 filed a third motion to compel the production of evidence. He requested that two individuals, an NASD compliance specialist who had investigated the complaint and a registered representative and compliance officer at Respondent Firm 1's Georgia office, be required to testify and that Respondent 2 be ordered to bring to the DBCC hearing his records concerning his telephone calls to Complainant 1 and his calls to other customers relating to the Company A transactions. By letter dated October 24, 1995, the DBCC granted this motion, but the DBCC specified that the compliance specialist would only be permitted to testify about his factual findings and that Respondent 2 should only produce his records relating to telephone conversations between September 1 and December 31, 1993.

On September 26, 1995, Respondent 2, after a lively exchange of correspondence with Complainant 1, filed a motion to compel the production of documents by Complainant 1. Respondent 2 sought from Complainant 1: 1) tax returns for 1993 and 1994; 2) any statements showing net worth for the period of time between January 1992 and July 1995; 3) any computer analyses that Complainant 1 had relating to investments; 4) any computer information that Complainant 1 had relating to financial affairs; 5) any information that Complainant 1 had accessed via computer relating to investments; 6) any documents relating to any investment in which Complainant 1 had an interest or which Complainant 1 controlled, including investments in Complainant 1's wife's name; and 7) a certification that Complainant 1 had performed a complete search and production. Complainant 1 filed a response arguing, among other things, that his participation in the proceedings as a complainant should not require him to give up his privacy rights. He argued that he had produced sufficient information relating to his personal investments and net worth for the complaint to be considered, and he stipulated to certain annual income figures. He produced some additional documents and stated that he had "done his best to respond fully to the reasonable and relevant demands."

Respondent 2 filed a reply, arguing that evidence of Complainant 1's 1994 investments and of the investments in his wife's name was necessary to prepare a defense against Complainant 1's allegation that he had been unwilling to buy stocks with high P/E ratios. Respondent 2 again requested various documents.

By letter dated October 24, 1995, the DBCC partially granted Respondent 2's motion and required Complainant 1 to produce: 1) documents sent to him by Respondent Firm 1; 2) account statements for accounts in which Complainant 1 had a beneficial interest or power of attorney for the year 1993; 3) notes and analyses regarding Company A; and 4) documents relating to communications between Complainant 1 and others concerning the Respondent Firm 1 account.

On October 27, 1995, Complainant 1 filed a "response" to the DBCC's ruling on Respondent 2's motion. Complainant 1 asserted that the DBCC had no authority to order him to produce any documents. He produced new documents, although he reasoned that production of his wife's account statements was not required under the terms of the DBCC's order. He also requested that Respondent

2 be required to produce records relating to telephone calls between June 1 and December 31, 1993. On November 3, Respondent 2 responded. He asserted that the relevant period for all evidence, including his own telephone records and Complainant 1's investment records, was April 1993 through August 31, 1995. Respondent 2 asked that Complainant 1 be ordered to produce his trading records for that period.

By letter dated November 8, 1995, the DBCC modified its October 24 order and required Respondent 2 to produce phone records for April through December 1993. In addition, noting that Complainant 1's statements of his stock holdings included shares held in his wife's name, the DBCC requested Complainant 1 to produce account statements for both himself and his wife for the years 1993 and 1994. On November 13, 1995, Complainant 1 filed a "response" in which he complained that he had not received Respondent 2's November 3 letter until after the DBCC had acted on it. Complainant 1 stated that he "respectfully decline[d]" to comply with the DBCC's most recent ruling. He argued that the DBCC had no authority to compel him to produce documents, other than the "inherent authority" to dismiss the complaint if it found that the respondents were denied access to information "critical to a fair defense." He asserted that any attempt to exercise "unauthorized authority" would be "met with litigation conducted by professionals."

At the commencement of the DBCC hearing, Respondent Firm 1 and Respondent 2 joined in a motion to dismiss the complaint based upon Complainant 1's refusal to produce the documents required by the ruling of November 8. The DBCC hearing panel reserved ruling on this motion. The full DBCC, in its decision, denied the motion to dismiss in light of the findings and conclusions set forth below. The DBCC determined that the documents that Complainant 1 had refused to produce would not have significantly altered the DBCC's findings and thus were immaterial.

Decision

Cause One - Alleged Misrepresentation of P/E Ratio - Evidence. Complainant 1 claimed that Respondent 2 represented to him that the P/E ratio for Company A was 24, although the correct ratio was at least 40.

Complainant 1 opened his account with Respondent Firm 1 on April 28, 1993, after several phone solicitations by Respondent 2. Complainant 1's initial transactions with Respondent 2 were two purchases of Company B which settled in May 1993. On settlement date July 19, 1993, Complainant 1 sold the Company B stock and bought Company C. His next two transactions were the purchase and sale. He bought Company D on the day that he sold his Company A shares, and shortly thereafter he liquidated his account.

Complainant 1 testified that Respondent 2 called him on the day of the purchase, October 1, 1993, to solicit the purchase. Complainant 1 claimed that during the course of the solicitation, he asked Respondent 2 for the current P/E for Company A, and Respondent 2 responded that it was "24."

Complainant 1 produced a copy of notes he prepared during the conversation. The notes included the notation "P/E" and the number "24." Complainant 1 claimed that he had purchased the Company A stock in reliance upon the representation that Company A's P/E was 24.

Respondent 2 claimed that he had discussed with Complainant 1 Company A's P/E ratios for three different years, and that he had done so on September 28, rather than October 1. Respondent 2 testified, and his notes indicated, that he used a corporate financing report issued by Firm E for the Company A IPO and a share price of $19.50 to calculate the ratios for the years 1993 through 1995. He calculated the ratio for 1993 by annualizing the reported earnings per share for the first half of the year, $.24, to arrive at earnings of $.48 per share. He calculated the ratios for 1994 and 1995 by estimating that earnings would increase by 25 percent each year. Thus, he calculated that the P/E ratios were 40.5 (for 1993), 32.5 (for 1994), and 26 (for 1995).[5]

According to Respondent 2, during the September 28 conversation, Complainant 1 declined to purchase the Company A shares and instead indicated that he would check with his Firm E broker, since Firm E had been involved with the then-recent Company A IPO. Respondent 2 testified that on October 1, he again called Complainant 1 to discuss Company A. During this conversation, Respondent 2 claimed, Complainant 1 indicated that he had contacted his broker at Firm E to obtain additional information about Company A. Complainant 1 then placed the order for Company A.[6]

Respondent Firm 1 and Respondent 2 offered two documents to support their version of Respondent 2's discussions with Complainant 1. First, Respondent 2's notes on Complainant 1 in his broker's book listed the September 28 and October 1 telephone calls and their topic (Company A).[7]

---

5 Respondent Firm 1's compliance officer's written responses to Complainant 1's first two letters of complaint to Respondent Firm 1 contained different calculations. (The DBCC decision cited to these numbers.) The ratios in the Respondent Firm 1's compliance officer's letters were based upon a share price of $20 and earnings projections contained in a Firm E research report issued after Complainant 1 bought Company A. Respondent Firm 1's compliance officer's letters stated that the P/E ratio for 1993 was 47.6 and that the ratio for 1994 was 34.5. Respondent Firm 1's compliance officer's letters also noted that Respondent 2 recalled having told Complainant 1 that estimated earnings for 1995 were $.75 per share and that the P/E ratio for 1995 was approximately 26.

6 Complainant 1 denied having spoken with the Firm E representative Company A or informing Respondent 2 that he had done so.

Respondent 2 testified that he sent Complainant 1 a prospectus and the Firm E corporate financing report after the first telephone conversation. Complainant 1 testified that he never received these materials.

7 Although the DBCC described Respondent 2's notes as "contemporaneous," Respondent 2 testified that he occasionally updated his records after the fact. He testified that a

The notes regarding the September 28 conversation indicated that Company A's P/E ratio was discussed. Second, respondents offered Respondent Firm 1's telephone records, which showed that a 20-minute call was placed to Complainant 1 on September 28 and that a 13-minute call was placed to Complainant 1 on October 1.

Complainant 1 testified that he did not recall the substance of the telephone call on September 28. He indicated that he had not been listening very closely and that it was possible that the P/E ratios for Company A were discussed. He asserted, however, that he definitely recalled having asked for the P/E ratio on October 1 and having been given a single response, the number "24."

The respondents challenged Complainant 1's claim that he would not have bought Company A if he had been aware of the fact that it had a relatively high P/E ratio. Complainant 1 testified that during the Summer of 1993, he repeatedly had advised Respondent 2 that he was not interested in high P/E stocks. Respondent 2, however, denied having spoken with Complainant 1 between the middle of July 1993 and September 28, 1993. (Respondent 2's notes and Respondent Firm 1's telephone records supported Respondent 2's assertion that he had not spoken with Complainant 1 during the late Summer, although Respondent Firm 1's compliance officer admitted that the records might not have listed every call.)[8] Moreover, Respondent 2 testified that Complainant 1 had never objected to purchasing any stock on that basis.

The respondents argued that Company A's P/E ratio was characteristic of issuers in the telecommunications industry, and they adduced evidence that other issuers had higher P/E ratios in October of 1993, e.g., that Company E's P/E ratio was 27.5, Company F's was approximately 50, and Company G's was 37. The respondents also noted that on the day that Complainant 1 sold his Company A holdings, he bought Company D, a stock with a high P/E ratio. In addition, the respondents noted that prior to the Company A purchase, Complainant 1 had purchased Company B and Company C stocks which had no P/E ratios because the issuers had no earnings.

Complainant 1 argued that regardless of other investments he had made at other times, P/E ratios were particularly important to him at the time of the Company A purchase because he anticipated a market correction at that point in time.

---

notation as to a November 23 call was made after Complainant 1 complained.

[8] Respondent Firm 1's telephone records, which the DBCC did not mention in its decision, indicated that Respondent 2 spoke with Complainant 1 on the following dates in 1993: March 9, April 16 (for less than a minute), April 28 (for less than a minute), May 11, May 12, June 10, July 12, September 28, September 30 (for less than a minute), October 1, November 17, and November 30.

Complainant 1 argued that the respondents' statements were inconsistent and showed that their account of the events should be discredited. Complainant 1 noted that when Respondent Firm 1's compliance officer responded to Complainant 1's first two letters of complaint to Respondent Firm 1, Respondent Firm 1's compliance officer failed specifically to assert that Respondent 2 had told Complainant 1 three different P/E ratios or to assert that the discussion occurred in an earlier telephone conversation. Complainant 1 also noted: that Respondent Firm 1's compliance officer's letter failed to mention Respondent 2's telephone records and contained a reference to, and based calculations of the "correct" P/E ratios on, a research report that Firm E issued after Complainant 1's purchase of Company A; that in a May 26, 1994 statement, Respondent 2 gave an account of the transactions that did not contain all of the information that he gave in his testimony at the hearing; that Respondent 2's answer to the complaint erroneously referred to a Firm E report issued after Complainant 1 bought Company A; and that Respondent Firm 1's answer to the complaint denied that it gave any conflicting recommendations to any customers.[9]

Cause One - NBCC Findings. After hearing argument from both Complainant 1 and the respondents, we issued an Order dated January 29, 1997. We instructed the DBCC to clarify its findings with respect to the allegations of the first cause of the complaint. Specifically, we indicated that although "[t]he DBCC's language suggested that the DBCC concluded that Respondent 2 had advised Complainant 1 of all three P/E ratios, . . . the DBCC did not expressly make such a finding." Moreover, we instructed: "to find a violation as alleged, it is necessary to determine whether Respondent 2, in fact, told Complainant 1 the wrong P/E ratio."

On March 6, 1997, the DBCC issued an Order which made findings that Respondent 2 advised Complainant 1 of the three P/E ratios which he had calculated and that he had a rational basis for his calculations. It further found that Respondent 2 did not tell Complainant 1 the wrong P/E ratio as alleged.

On May 23, 1997, we issued a second Order in which we again instructed the DBCC to clarify its findings.

In an Order dated June 30, 1997, the DBCC found Respondent 2 more credible than Complainant 1 concerning the October 1 conversation:

> As we have repeatedly stated in this proceeding, Respondent 2's version of the September 28 conversation wherein he claims that the

[9] Complainant 1 argued, based on these alleged inconsistencies, that the respondents should be discredited. Complainant 1 also argued, based on the alleged inconsistencies and on the respondents' conduct toward him, that the respondents had demonstrated bad faith warranting disciplinary sanctions.

> P/E ratios were discussed is uncontroverted in that Complainant 1 acknowledged that he wasn't listening closely and it was possible that P/E ratios were discussed. Therefore, we credit Respondent 2's version of this conversation. Given this fact, we question why Respondent 2 would contradict himself in the October 1 conversation and tell Complainant 1 that Company A had a P/E of 24. It is even more unlikely since the conversations were within three days of each other. Moreover, there is no evidence that Respondent 2 was aware that Complainant 1 was not listening closely during the September 28 conversation, thereby increasing the likelihood that he would not contradict himself in the follow-up conversation. We do not believe he did.
>
> * * * *
>
> We do not find any inconsistencies in Respondent 2's testimony or inconsistencies between his testimony and the documentary evidence. His recollection was not selective but fairly complete considering that the events at issue occurred during 1993. Moreover, he did not exhibit any evasiveness during his testimony.
>
> * * * *
>
> In view of the forgoing, we **find** that Respondent 2 advised Complainant 1 of the three P/E ratios which he calculated for Company A during the September 28 conversation. We **find** that he did not make them up but rather had a rational basis for his calculations. We further **find** Respondent 2's version of the October 1 telephone call more credible than Complainant 1's version. Consequently, we **find** that Respondent 2 did not misrepresent the Company A P/E ratio to Complainant 1, as alleged, during the October 1 conversation. In view of the foregoing, we reaffirm our dismissal of the first cause of the Complaint.

<u>Cause One - NBCC Findings.</u> Based on an independent review of the evidence and arguments, we find no reason to question the credibility and evidentiary findings of the DBCC as set forth in its Orders dated March 6 and June 30, 1997 and its Decision dated March 15, 1996. The DBCC was in a position to view and assess the demeanor of the witnesses, and the extrinsic evidence cited by the DBCC is consistent with its findings. The DBCC's findings establish the existence of a misunderstanding, but no misrepresentation or other unethical behavior. We thus affirm the DBCC's dismissal of the allegations of cause one.

Cause Two - Suitability and Allegedly Inconsistent Recommendations - Evidence. Complainant 1 noted in an October 4, 1995 response to a discovery motion, that his use of the term "suitability" in cause two was inappropriate. In addition, he testified at the DBCC hearing that he was not contending that the purchase of Company A was unsuitable for someone with his investment objectives, income, and net worth.[10]

Complainant 1 claimed that when Respondent 2 recommended to Complainant 1 the purchase of Company A, the respondents were, at or about the same time, recommending that other clients sell Company A, and vice versa. Complainant 1 argued that other customers or the firm itself were given treatment preferential to that given to him.

Respondent 2 testified that he recommended Company A to five of his customers, including Complainant 1, during the month after the IPO, and that all of them purchased Company A. He acknowledged that five days after Complainant 1 bought Company A, one customer sold his interest in Company A. Respondent 2 testified that that customer had a practice of holding new issues for a very short period of time. Respondent 2 testified that he later recommended the sale of Company A to all of the customers who continued to hold it, including Complainant 1, and that all of the other customers sold their interests prior to Complainant 1.

Cause Two - DBCC Findings. The DBCC found that the Company A recommendation was suitable for Complainant 1 because his investment in Company A was only a fraction of his net worth and was consistent with his investment objective.

The DBCC noted that although Complainant 1 had worded cause two in terms of suitability, the second cause really contained an allegation of unfair dealing and/or conflicting recommendations. The DBCC noted that Complainant 1 had indicated that he felt cheated when he authorized the sale of Company A at a loss, and that he felt that the fees that he paid for the transaction were inappropriate.

---

[10] Complainant 1, who was born in 1935, is an attorney. After graduating from law school in 1965 and briefly practicing law, he served as a dean of the law school for 18 years, including seven years as assistant dean for financial and general administration. He subsequently worked as director of administration for a law firm and as vice president for business and finance for an architectural firm. Complainant 1 testified that in 1993, he had retired and was looking for consulting work. He testified that in 1993, he was interested in becoming more active in the stock market. Although he listed $75,000 as his annual income on his new account form, he testified that his actual income was lower. He testified that his net worth was accurately listed on the new account form as approximately $2 million. He maintained securities accounts with other member firms and had a total portfolio of individual securities worth approximately $250,000 in October 1993. The new account form listed his investment objective as "growth."

The DBCC noted, citing In re Ernest A. Cipriani, Jr., Exchange Act Rel. No. 33675 (Feb. 24, 1994), that in NASD disciplinary actions, the burden of proof is on the complainant. The DBCC noted that a complainant must show by a preponderance of evidence, i.e., that it is more likely than not, that the alleged violations occurred.

The DBCC found that Complainant 1 had not met the burden of proof regarding the second cause of the complaint.[11] The DBCC noted that Complainant 1 had acknowledged in a discovery filing that if Respondent 2 could demonstrate that he had provided the same advice to all his customers with respect to Company A, then he violated no rule. The DBCC noted that the only evidence regarding possibly conflicting recommendations by Respondent 2 related to one customer's sale of Company A five days after Complainant 1 bought it. The DBCC noted that Respondent 2 had testified that this sale was initiated by the customer. Thus, finding that Complainant 1 had not sustained his burden of proof, the DBCC dismissed the second cause.

Cause Two - NBCC Findings. We affirm the dismissal of cause two of the complaint. First, like the DBCC, we find, based on the evidence and on Complainant 1's admissions, that the recommendations that Respondent 2 made to Complainant 1 regarding Company A were suitable.

Second, we reject Complainant 1's assertion that because he had repeatedly refused to purchase high-P/E stocks from Respondent 2, it was a per se violation of Section 2 for Respondent 2 to recommend Company A to him.[12] Even assuming that Complainant 1 did repeatedly decline proposals to buy high-P/E stocks during the Summer of 1993, an assumption that is not established by the record, Respondent 2's recommendation of Company A, standing alone, could not have been a per se violation of Section 2, because the recommendation was suitable for Complainant 1.

Complainant 1's allegations under the second cause appear to relate more to unfair dealing -- or even manipulation -- than to suitability. Cause two alleged a violation of Section 2, but not of Section 1 or any anti-fraud provision. Assuming for purposes of argument that manipulative, conflicting recommendations violate the Rules and that the complaint could fairly be read to allege such misconduct, we nonetheless affirm the dismissal of cause two. At the outset, we note that nothing in the NASD's Rules or the securities laws requires that identical recommendations be given to every customer. Instead, the Rules require that there be a reasonable basis for recommendations of particular securities to particular customers.

---

[11] The DBCC analyzed only Complainant 1's claim that Respondent 2 had made conflicting recommendations; the DBCC did not consider the allegation that the firm had done so.

[12] Complainant 1 claimed that he had no interest in high-P/E stocks. The DBCC rejected this claim, noting that the respondents adduced evidence that Complainant 1 had bought other high-P/E stocks.

Like the DBCC, and based on Complainant 1's admission before the NBCC, we find that there is no evidence suggesting that Respondent 2 made conflicting recommendations to his customers.

Although the DBCC did not consider Complainant 1's allegation under cause two that Respondent Firm 1 made conflicting recommendations, this allegation must be dismissed, as well. The record evidence showed that Respondent Firm 1 engaged in numerous transactions, including both purchases and sales, involving Company A during the days surrounding Complainant 1's transactions.[13] As discussed above, the DBCC denied Complainant 1's request that the DBCC order Respondent Firm 1 to produce detailed information about each of the solicited transactions. Complainant 1 argued on appeal that Respondent Firm 1 should be required to demonstrate that each of its contemporaneous conflicting recommendations was based on analysis of the relevant suitability factors. Complainant 1 argued that the burden of proof had shifted to Respondent Firm 1, and that Respondent Firm 1 should be required to show that the financial and investment factors for any customers who received different recommendations differed from those applicable to Complainant 1. At the appeal hearing, Complainant 1 argued that it is common knowledge that members of the securities industry violate their obligations under Section 2, due to a desire to earn commissions and trading profits. Complainant 1 argued that the NASD should take action against Respondent Firm 1 under cause two to reform the securities industry.

We find that the record contains no evidence suggesting that Respondent Firm 1 violated its suitability obligations under Section 2 with respect to any of the other customers who effected transactions in Company A. Thus, Complainant 1did not meet the burden of proof for this allegation, and there is no basis in law for finding that the burden of proof shifted to Respondent Firm 1.

We acknowledge that because the DBCC refused to order Respondent Firm 1 to produce information about its transactions with other customers, it was not possible for Complainant 1 to obtain information in support of his theory that some of Respondent Firm 1's recommendations might not have met the requirements of the suitability rule. We find, however, that the DBCC acted properly in refusing to order Respondent Firm 1 to produce additional information.[14] Complainant 1 offered no evidence of any impropriety in the transactions with other customers, apart from the fact that some recommendations might have been made that were different from the recommendations made to Complainant 1. As previously stated, nothing in the Rules prohibits a member firm from making different recommendations to different customers. Based on the lack of any threshold evidence of a violation, it would have been inappropriate and unduly burdensome to Respondent Firm 1 to permit

[13] Respondent Firm 1's research department never issued any official recommendations with respect to the stock.

[14] Complainant 1 argued on appeal that some form of statistical analysis could be used to evaluate Respondent Firm 1's recommendations, without necessitating that confidential information be revealed. We note, however, that any such analysis also would require the production of substantial additional evidence by Respondent Firm 1.

Complainant 1 to conduct a "fishing expedition" by reviewing records of the firm's transactions with other customers.

Cause Three - Failure to Disclose Financial Interest - Evidence. The third cause alleged that Respondent Firm 1 and Respondent 2 violated Sections 1 and 14 in that they failed to disclose, until the transactions were complete, that Respondent Firm 1 was the seller of the Company A shares sold to Complainant 1 and was the purchaser of the Company A shares sold by Complainant 1.

Complainant 1 acknowledged that he received confirmations for both of the transactions. Each confirmation indicated that Respondent Firm 1 made a market in Company A. Under the heading "C" (for "capacity"), the confirmations indicated the number "7," which the back of the confirmation translated to denote a principal transaction.

Complainant 1 claimed that the confirmations were confusing and that he had not understood the implications of the fact that Respondent Firm 1 was a market maker in Company A. Complainant 1 further claimed that the disclosure was made "after the fact," since he received the confirmations after the trades were executed.[15]

Cause Three - DBCC Findings. The DBCC noted that Section 14 requires disclosure "at or before the completion" of transactions. The DBCC found that Respondent Firm 1's confirmations disclosed the firm's capacity before payment and thus completion of the transactions. In addition, the DBCC found that Respondent Firm 1's disclosures that it made a market in the subject security and that it was acting as a principal for the transactions were in compliance with the requirements of SEC Rule 10b-10.

The DBCC found that Respondent Firm 1 did not appear to have engaged in any "nefarious trading scheme." Instead, the DBCC found, the trading appeared to be routine market making. Complainant 1 claimed that within 10 days of Respondent 2's recommendation to him to purchase Company A common stock, Respondent Firm 1 sold 466,255 shares, and that within 10 days of the sell recommendation, Respondent Firm 1 purchased 252,627 shares. Complainant 1 concluded based on this information that Respondent Firm 1 took positions contrary to the recommendations it made to its customers. However, the DBCC found that Complainant 1 had failed to consider Respondent Firm 1's purchases and sales during the respective 10-day periods.

More importantly, the DBCC noted, Complainant 1 had failed to consider Respondent Firm 1's inventory positions during the relevant periods. (The DBCC noted that Complainant 1 had not had

[15] Complainant 1 testified at the DBCC hearing, in response to questions from the respondents' counsel, that he had bought stock on various occasions without any concern about the fact that the firms from which he bought the stocks were acting as market makers.

access to Respondent Firm 1's inventory positions until the information was produced in anticipation of the hearing.) This information indicated that on October 1, 1993, the day that Complainant 1 purchased Company A, Respondent Firm 1’s inventory position in Company A did not change. On November 30, 1993, the day that Complainant 1 sold his holdings in Company A, Respondent Firm 1 opened the day with a short position and ended the day with a larger short position.

In view of the foregoing, the DBCC found nothing in the trading and confirmation disclosure practices of Respondent Firm 1 to be contrary to industry practice or in violation of the Rules. Thus, the DBCC dismissed the third cause of the complaint.

<u>Cause Three - NBCC Findings.</u> We observe that the third cause alleged violations of Sections 1 and 14. We affirm the dismissal of those allegations.

We find that Section 14 was not applicable to Respondent Firm 1’s conduct in this matter.[16] The provision, which has existed in its current form in the Rules of the NASD for at least 30 years, does not appear to have been the subject of any reported decisions or Notices to Members in recent years. The provision's language indicates that it is applicable only to members engaged in distributions of securities. Section 14 is entitled "Disclosure of Participation or Interest in Primary or Secondary Distribution," and it contains the key clause "in any security in the primary or secondary distribution of which such member is participating or is otherwise financially interested." Thus, the provision was inapplicable to Respondent Firm 1's market-making in Company A.

In any event, we find that even if Section 14 were applicable to Respondent Firm 1's transactions with Complainant 1, and even if Respondent Firm 1’s capacity as a market maker gave it a "financial interest" in the transactions, the firm gave Complainant 1 sufficient "written notification of the existence of [its financial interest]" in the transaction "at or before the completion of the transaction" by sending the confirmations to him. The confirmations, which contained the disclosures regarding capacity required by SEC Rule 10b-10, adequately notified Complainant 1 of the firm's role in the transactions.

---

[16] Section 14 (now Conduct Rule 2250), which is entitled "Disclosure of Participation or Interest in Primary or Secondary Distribution," provides that:

> A member who is acting as a broker for a customer or for both such customer and some other person, or a member who is acting as a dealer and who receives or has promise of receiving a fee from a customer for advising such customer with respect to securities, shall, at or before the completion of any transaction for or with such customer in any security in the primary or secondary distribution of which such member is participating or is otherwise financially interested, give such customer written notification of the existence of such participation or interest.

We find that Section 14 required no additional disclosure to be made by Respondent Firm 1 .

Likewise, we reject Complainant 1's argument that Respondent Firm 1 violated Section 1 by neglecting to disclose sufficient information about the market-making capacity in which the firm acted. Section 1 requires adherence to "high standards of commercial honor and just and equitable principles of trade." We find that Respondent Firm 1's disclosures of its market-making capacity were consistent with the standards of the industry and with the detailed provisions of SEC Rule 10b-10.

Finally, we affirm the DBCC's dismissal of Complainant 1's original theory under cause three. Prior to obtaining information about Respondent Firm 1's proprietary trading in Company A, Complainant 1 appears to have believed that the firm might have had an adverse "financial interest" in the transactions in the sense that the firm had used its transactions with Complainant 1 to assist it in efforts to obtain desired inventory positions. Complainant 1 appears to have suspected that the firm had sold Company A to him at a time when it wanted to reduce its holdings, and that the firm encouraged him to sell at a time when it wanted to increase its holdings because it anticipated favorable developments. (This theory is actually more in the nature of a claim of manipulation or fraud.) Respondent Firm 1 proved that its inventory position remained stable (and virtually flat) on the day that Complainant 1 bought Company A, and that it increased thereafter. The day that Complainant 1 sold his shares, the firm's inventory position opened with a short position and closed with a much larger short position. Given these facts, we find that Complainant 1 has not proven that any "financial interest" existed which should have been disclosed. We note, however, that even if the evidence had shown that the firm's proprietary positions changed in a fashion complementary to Complainant 1's position, such evidence would not, standing alone, establish any violative conduct.

Based on the foregoing, the allegations of the complaint are dismissed in their entirety.

On Behalf of the National Business Conduct Committee,

Joan Conley, Corporate Secretary