

BEFORE THE NATIONAL ADJUDICATORY COUNCIL
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of

Department of Enforcement,

Complainant,

vs.

Robert H. Watkins
Garland, TX,

Respondent.

DECISION

Complaint No. 2009018771602

Dated: December 31, 2013

The Hearing Panel found that the respondent recommended an unsuitable collateralized mortgage obligation to a customer in violation of the suitability rule. Held, the Hearing Panel’s findings are reversed and the proceedings dismissed.

Appearances

For the Complainant: Laura Leigh Blackston, Esq., David B. Klafter, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Steven M. Malina, Esq., Beth A. Black, Esq.

Decision

Pursuant to FINRA Rule 9312, the Review Subcommittee of the National Adjudicatory Council (“NAC”) called for review an October 12, 2012 Hearing Panel decision. In that decision, the Hearing Panel found that Robert H. Watkins (“Watkins”) violated NASD Rules 2310 and 2010 by making an unsuitable recommendation to a customer. For this violation, the Hearing Panel censured Watkins and fined him \$5,000.

After reviewing the record, we dismiss the allegations against Watkins.

I. Background

Watkins entered the securities industry in September 1993. In December 2002 Watkins registered with Northern Trust Securities, Inc. (“Northern Trust” or “the Firm”), as a general securities representative. Watkins voluntarily resigned from Northern Trust in March 2011, and

the Firm terminated his registration in April 2011. Watkins is not currently associated with a FINRA member.

II. Procedural History

On October 7, 2011, FINRA's Department of Enforcement ("Enforcement") filed a one-cause complaint alleging that Watkins made a single, unsuitable recommendation to a customer, in violation of NASD Rules 2310 and 2110. In a decision issued on October 12, 2012, the Hearing Panel found Watkins liable for the alleged violation. The Hearing Panel censured Watkins and fined him \$5,000 for this violation. On November 21, 2012, the NAC Review Subcommittee called this matter for review.

III. Facts

In February 2007, VG was a customer of Watkins. At this time, she had a bank account at Northern Trust and a brokerage account ("Initial Account") at another broker-dealer. The Initial Account was valued at more than \$800,000 and included equities (three stocks valued at \$389,797.65), mutual funds (valued at \$391,686.58), eight mortgage-backed bonds known as "Ginnie Maes" (valued at \$25,478.61), and a cash balance of \$1,086.38. After VG expressed her dissatisfaction with the investments in her Initial Account to a Northern Trust bank teller, the bank teller referred VG to Watkins.

VG first met Watkins in March 2007 at an in-person meeting at her residence. At this meeting, VG represented that she had 40 years of investment experience in equities and fixed income and 10 years of experience in mutual funds. The parties stipulated that Watkins obtained the necessary "know your customer" and suitability information from VG to complete her new account application, including her age, tax status, financial information (including net worth), investment objectives and investment experience.¹ VG's primary investment objective was "current income" and she had a "moderate" risk tolerance. VG informed Watkins that she relied on investment income and Social Security to pay her living expenses and that she needed her investment portfolio to generate \$3,000 a month.

Watkins investigated various possible investments for VG, including collateralized mortgage obligations ("CMOs"), corporate bonds, treasuries, and CDs, but he felt that only the CMOs would produce the monthly income that VG desired. After speaking with the person at Northern Trust responsible for CMOs, Watkins determined that a Countrywide CMO ("Countrywide CMO") was the investment best suited for VG's needs. The Countrywide CMO was AAA-rated and collateralized with prime-backed loans—having no exposure to sub-prime mortgages. The Countrywide CMO contained several senior tranches that offered monthly payments to investors with more pre-payment risk assigned to tranches that were not senior

¹ The suitability rule that applies in this case is NASD Rule 2310—the rule that existed at the time of the conduct at issue. FINRA's amended suitability rule (FINRA Rule 2111) does not apply to this case.

tranches. The tranche that Watkins recommended to VG was a senior tranche with a fixed interest rate of 6.0 percent and a maturity date of February 25, 2037.

At a second in-person meeting in March 2007, Watkins recommended the purchase of 400,000 units (worth \$400,000) of the Countrywide CMO. At this second meeting, Watkins met with VG for over an hour and explained to her how the Countrywide CMO would fit with VG's portfolio and Watkins's plan for selling some of her equities to diversify her account. Watkins also provided VG with information that explained how CMOs worked and the risks associated with them.

Upon Watkins's recommendation, VG purchased the Countrywide CMO worth \$400,000 in March 2007.² Watkins estimated that VG's total monthly income would be more than \$3,000 per month, which would include Social Security payments, the Countrywide CMO and income from other investments. Watkins received approximately \$800 as his commission on the transaction. Nearly a year later, after the virtual collapse of the housing market, VG transferred her account to a different broker and he sold all of the Countrywide CMO for approximately \$.79 on the \$1 for a realized loss of \$86,275.³ VG subsequently filed a complaint against Northern Trust and entered into arbitration against Northern Trust. The Firm settled the arbitration with VG for \$82,000.

IV. Discussion

A. The Suitability Rule Requires a Broker to Make Reasonable Recommendations

"NASD Rule 2310, sometimes referred to as the 'suitability rule,' requires that, in recommending the purchase, sale, or exchange of any security to a customer, a member must have reasonable grounds for believing that the recommendation is suitable for that customer based on the facts, if any, disclosed by the customer as to his other securities holdings and the customer's financial situation and needs."⁴ *Id.* at *3 n.2. "The suitability rule . . . requires a broker to make a customer-specific determination of suitability and to tailor his recommendations to the customer's financial profile and investment objectives." *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168 (1989).

² This purchase was made by selling approximately \$200,000 of the equities and approximately \$200,000 of the mutual funds that were in VG's Initial Account.

³ Nine months after VG sold the Countrywide CMO, it lost its AAA rating. By June 8, 2009, the Countrywide CMO was rated CCC.

⁴ "A violation of Rule 2310 constitutes a violation of Rule 2110, which requires registered representatives to 'observe high standards of commercial honor and just and equitable principles of trade.'" *Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at *26 (May 27, 2011) (quoting NASD Rule 2110).

Initially, a broker must have a reasonable basis to believe, after performing reasonable due diligence, that the recommendation could be suitable for some investors (reasonable-basis suitability). *Id.* at 164, 168 & n.16. “A registered representative can also violate the suitability rule if he or she inadequately assesses whether the recommendation is suitable for the specific investor to whom the recommendation is directed (customer-specific unsuitability)” *William J. Murphy*, Exchange Act Release No. 69927, 2013 SEC LEXIS 1933, at *38 (July 2, 2013) (internal quotations omitted). The Commission has acknowledged that a broker must make an independent suitability determination for a customer before recommending a security to the customer. *See Nazmi C. Hassanieh*, 52 S.E.C. 87, 89 (1994) (discussing a broker’s “obligation to make an independent determination that [an] investment [is] suitable”).

A broker must also disclose the risks associated with a recommended security to a customer, but “[m]ere disclosure of risks is not enough. A [broker] must ‘be satisfied that the customer fully understands the risks involved and is ... able ... to take those risks.’” *James B. Chase*, 56 S.E.C. 149, 159 (2003) (quoting *Patrick G. Keel*, 51 S.E.C. 282, 284 (1993)). This is particularly true when a broker is assessing whether a recommendation is suitable for senior investors. *See FINRA Regulatory Notice 07-43*, 2007 FINRA LEXIS 42, at *4 (Sept. 2007) (stating that “[a]lthough the [suitability] rule does not explicitly refer to a customer’s age or life stage, both are important factors to consider in performing a suitability analysis And, depending on their particular circumstances, seniors and retirees may have less tolerance for certain types of risk than other investors”). Even if a broker understands the specific risks and explains them to a customer in making a recommendation, the customer’s understanding of the risks and acquiescence in following the recommendation does not “relieve [a broker] of his obligation to make reasonable recommendations.” *Jack Stein*, Exchange Act Release No. 47335, 2003 SEC LEXIS 338, at *14 (Feb. 10, 2003). “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.” *Dane S. Faber*, Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (Feb. 24, 2004) (citation omitted).

“FINRA has often reminded firms of the obligation to assess the potential risks associated with products that raise specific investor protection concerns.” *FINRA Notice to Members 12-03*, 2012 FINRA LEXIS 3, at *1 (Jan. 2012). FINRA thus has acknowledged that complex products, such as asset-backed securities, present “additional risk to retail investors because [their] complexity adds a further dimension to the investment decision process beyond the fundamentals of market forces.” *Id.* at *9. With regard to CMOs specifically, FINRA has stated that “a registered representative who recommends a collateralized mortgage obligation should understand the various features of the instrument, including the prepayment, credit and liquidity risks associated with the collateral and the particular tranche being recommended.” *Id.* at *19.

B. The Record Does Not Establish that Watkins Made Unreasonable Recommendations

In evaluating the record in this case, we apply a preponderance of the evidence standard. *See Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of the evidence standard in a disciplinary proceeding for FINRA’s predecessor, NASD); *Richard G. Cody*, Exchange Act Release No. 65235, 2011 SEC LEXIS 3041, at *5 (Aug. 31, 2011) (noting on appeal how FINRA applied the preponderance of the evidence standard in the proceedings below to establish suitability violations). Here, the preponderance of the evidence does not support the Hearing Panel’s finding of a violation.

The Hearing Panel decision described the Countrywide CMO as an “interest only” tranche, but—in another part of the decision—stated that the CMO paid interest monthly for some years before starting to pay back principal. The Hearing Panel concluded that the CMO was inappropriate for VG because its panelists believed that the Countrywide CMO was an “interest only” tranche. The Hearing Panel found Watkins violated the suitability rule because FINRA has stated that “interest only” tranches should only be sold to a sophisticated investor with a high-risk profile⁵ and VG was not such an investor.

The Hearing Panel’s assumption was incorrect. Based on our review of the Countrywide CMO, the tranche was not interest only; it was structured to eventually make substantial payments of principal after earlier tranches had been paid off. The Hearing Panel’s misunderstanding was the basis for its central finding that an interest only tranche is a high risk product. The record below therefore does not establish that this senior tranche of the Countrywide CMO, which was given a AAA rating, was a high risk product. Of the tranches available in the Countrywide CMO, we recognize that VG purchased a more senior tranche, but we still have concerns about whether Watkins’s recommendation of the Countrywide CMO resulted in overconcentration of VG’s investments. Nevertheless we cannot uphold a finding of overconcentration because the record does not contain sufficient evidence. There is no evidence of the overall effect on VG’s investments from selling \$200,000 worth of three stocks and making a large purchase of the Countrywide CMO. We are not confident that VG’s investments were subject to greater concentration risk as a result of Watkins’s recommendation, and the record does not provide applicable evidence on this point.

Accordingly, we reverse the Hearing Panel’s finding of liability. Our decision does not suggest that we have concluded that Watkins’s recommendation was suitable, only that we cannot conclude from the record that the recommendation was unsuitable.

⁵ *NASD Notice to Members 93-73*, 1993 SEC LEXIS 175, at *8 (Oct. 1993).

V. Conclusion

We reverse the Hearing Panel's findings that Watkins made an unsuitable recommendation in violation of NASD Rules 2310 and 2110. This was the only allegation in Enforcement's complaint. Consequently, we dismiss this disciplinary action against Watkins.

On Behalf of the National Adjudicatory Council,

Marcia E. Asquith, Senior Vice President and
Corporate Secretary