BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 1 Complainant, vs. Daniel Wright Sisson Menlo Park, California, Respondent.	AMENDED DECISION Complaint No. C01960020 District No. 1 Dated: November 18, 1998

The October 17, 1997 decision of the District Business Conduct Committee for District No. 1 ("DBCC") regarding Daniel Wright Sisson ("Sisson") was called for review pursuant to NASD Procedural Rule 9312.[1] We find that Sisson violated NASD Conduct Rules 2110 and 2310 by recommending trades that were unsuitable as to size and frequency in the accounts of two customers. Accordingly, we order that Sisson be censured, fined $35,000, suspended from association with any member of the Association in any capacity for 10 days, required to requalify within 120 days of the release of this decision, and assessed DBCC hearing costs.

[1] The National Business Conduct Committee ("NBCC") of NASD Regulation, Inc. ("NASD Regulation") called this case for review to determine whether the sanctions imposed by the DBCC were adequate given the DBCC's finding that Sisson made unsuitable recommendations in two customers' accounts. This matter was decided by the National Adjudicatory Council ("NAC"), which, as approved by the Securities and Exchange Commission, became the successor to the NBCC on January 16, 1998.

Factual Background

Sisson entered the securities industry in 1966. He was registered as a general securities principal from 1979 through 1982 with Smith Barney, Harris & Upham, Inc. ("Smith Barney"), and from 1983 through 1984 with Morgan, Olmstead, Kennedy, and Gardener ("Morgan, Olmstead"). From March 1984 to May 4, 1994, Sisson was employed by Portsmouth Financial Services ("Portsmouth"), where he was registered as a general securities and options principal. Sisson is currently employed by another NASD member as a general securities representative.

In May of 1994, Portsmouth terminated Sisson and filed with the NASD a Uniform Application for Securities Industry Registration or Transfer ("Form U-5") stating that the termination resulted from a complaint from RF, the son of deceased customer KP, alleging excessive trading and unsuitability. While investigating RF's complaint, the NASD learned of and investigated a complaint of similar misconduct by Sisson that JD, filed on behalf of his mother, ED, another former customer of Sisson's. This disciplinary action resulted from the NASD's investigation of Sisson's termination.

Customer KP and Her Account With Sisson

According to her son, KP was born in 1916. She completed a two-year program at Stevens College where she studied business, secretarial skills, and office work. Prior to 1979, she had worked for several years as the office manager of an advertising firm. In 1979 KP began working for Saga Food Corporation ("Saga") as the secretary to several senior executives, a position she held until her retirement in the mid-1980s. KP was an inexperienced investor; she inherited and held approximately $25,000 in telephone stocks, but had no other investing experience. She did not own her own home.

KP met Sisson through Sisson's wife, who also worked at Saga. In 1979, KP opened a brokerage account with Sisson at Smith Barney. She transferred the account to Morgan, Olmstead when Sisson moved there in 1983, and transferred it to Portsmouth when Sisson moved there in 1984. KP's account remained at Portsmouth until her death in 1992.

Sisson controlled the trading in KP's account. In his answer to the complaint, Sisson stated that he always explained his investment recommendations to KP and that she "always accepted them." From 1979 through 1987, Sisson had KP make conservative investments. Sisson had KP invest primarily in money market funds from 1979 until 1985, and then he switched her investments to United States Government-securities funds. KP remained invested in these funds until April 1988. From 1979 through April 1988, KP contributed approximately$50,000 to the brokerage account. The value of her account grew to more than $93,000, and the account generated $650 in monthly income, which supplemented her $800 monthly Social Security benefits.

Sisson's allegedly violative conduct occurred between June of 1988 and January of 1991. Sisson admitted in his answer that in April 1988, he sold KP's government securities funds and switched her investments to high-yield, preferred stocks and limited partnerships. Sisson opened a margin account for KP in August 1988, but that account remained dormant until December of 1988.

Sisson admits that he changed the investment strategy for KP's account after she decided to move from her rented property to a retirement community. In December 1988 she selected a residence that required an initial deposit of $14,000 and monthly payments of $733. According to Sisson, KP told him that she wanted to use income from her brokerage account to pay the monthly costs of the retirement community.

To produce the extra income that KP requested, Sisson increased the trading activity in KP's account and implemented a margin trading strategy whereby he attempted to purchase on margin equities that yielded more than the margin cost of carrying them. Sisson rapidly increased KP's margin activity. At the end of December 1988, the debit in KP's margin account exceeded $5,000, and at the end of January 1989, it exceeded $10,000, roughly 12 percent of KP's equity. In March 1989, KP withdrew $15,500 (including the $14,000 down payment to the retirement community) from her account, decreasing her equity to $54,000 and increasing the margin as a percentage of equity to 18 percent.

Sisson's trading strategy temporarily increased the value of KP's account, before it sank dramatically lower. Between March 1989 and May 1990, Sisson executed 32 purchases and 29 sales in KP's account, and the equity increased from $54,289 to $79,776, despite cumulative withdrawals of $8,950.[2] Between May and October of 1990, Sisson executed 17 purchases and 17 sales in KP's account, but the value of her securities decreased from a May 1990 high of $79,000, to $66,040 in July, $46,502 in August, and $30,303 in October, including cumulative withdrawals of $3,900. Sisson testified that the onset of Operation Desert Storm in August of 1990 reversed KP's fortunes.

Sisson's new strategy in KP's account was costly. Between June 1988 and January 1991, Sisson collected $38,881 in commissions from KP's account. During that same period, KP's account suffered realized and unrealized losses of $38,930. Sisson does not dispute these figures, but he claims that his strategy succeeded because the account generated the amount of income that KP had requested.

In January 1991, KP's son took control of her account. KP's condition had deteriorated and she was moved to an assisted-living unit in the retirement community. KP's son assumed control of KP's account for medical reasons.[3] In the Summer of 1993, RF complained to

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[2] In August 1989, KP executed a trading authorization in favor of Sisson.

[3] Sisson claims that, but for RF's interference, he would have recovered KP's entire loss. Between January and August of 1991, Sisson continued trading in the account, with RF's approval, and by August he had restored KP's equity to $62,171. RF then prevented Sisson from trading in the account and, by August 1992, the equity decreased to $23,318. Sisson claims that RF prevented him from liquidating securities positions that caused the loss in KP's account.

Portsmouth about Sisson's conduct, and Portsmouth settled with KP's estate for $30,000 in March 1994.

Customer ED And Her Account With Sisson

Like KP, ED was a long-term client of Sisson's. She and her husband, RD, opened a joint brokerage account at Smith Barney with Sisson in 1978. They transferred the account to Morgan, Olmstead in 1983, and transferred it to Portsmouth in 1984. In 1986, they opened a margin account with Portsmouth and, in 1990, they converted the joint account into a family trust. The account remained at Portsmouth until 1994.

Although the couple's new account card showed their investment objective to be income, it also showed that they were willing to speculate. RD was an active investor and controlled the account, frequently requesting advice and research materials from Sisson. He favored aggressive investments and used margin trading to augment his returns. In fact, when the account was converted to a trust in 1990, the controlling trust document specifically stated that the funds could be invested in "an aggressive manner" and "need not be diversified." Between 1986 and 1991, RD increased the couple's trading activity and use of margin. The account incurred commissions of $11,576 in 1989, $23,369 in 1990, and $18,241 in the first seven months of 1991.

RD died in August 1991, and ED became sole trustee of the account. At the time of RD’s death, ED was 64 years old, retired, and an unsophisticated investor. She had never held a securities account prior to her husband’s dealings with Sisson, and had never placed any orders prior to his death. It is doubtful that ED followed or understood either the activity or level of risk present in their account.

Despite RD's death, the activity in the account was little changed. According to Sisson, the "account was basically a continuation of what [RD] had been doing." Sisson traded primarily the same equities that RD had traded, used margin as RD had used it, and charged commissions similar to those RD had incurred. Sisson stated that the activity in the account was "absolutely consistent with her husband's objectives." He also stated that he explained the reasons for the transactions to ED, and that she received trade confirmations in the mail, as required. ED accepted all of Sisson's advice and explanations for the activity in the account.[4]

Sisson also claims that he had sold those positions from his other accounts and avoided similar losses. Because the complaint covers only the period when Sisson controlled KP's account, June of 1988 through January of 1991, this subsequent activity in the account is irrelevant.

[4] ED made one independent decision regarding the account: following her husband's death, she informed Sisson that she wanted all dividends generated by the account to be paid out to her. Beginning in September 1991, there were a series of withdrawals from the account, reflecting ED’s request. There is no evidence that ED exercised any other control over the account or over Sisson's trading in it.

Between September 1991 and July 1993, purchases in the account totaled $636,528. The average monthly equity for the account was $129,915. The turnover ratio was 2.45 times on an annualized basis. In order simply to recover the commissions and interest paid, the account would have needed to generate an annual return of 19 percent. The account would have had to generate an annual return of almost 14 percent simply to recover the commissions paid. During the period in question, the account suffered losses, both realized and unrealized, of $112,189.66, and paid commissions of $52,008.22.

In 1994, ED's son objected to the activity in her account. Portsmouth settled ED's arbitration claim for $100,000.

Discussion

The complaint alleged that Sisson violated Conduct Rules 2110 and 2310 by making recommendations that were unsuitable in size and frequency considering KP's and ED's respective financial situations. The gravamen of the complaint was that Sisson placed his interests ahead of those of his clients by engaging in excessive trading in their accounts. The NASD Board of Governors' policy statement with respect to fair dealing with customers, which appears in the NASD Manual following the suitability rule, provides in pertinent part as follows: "Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are . . .excessive activity in a customer's account. . . ." IM 2310-2.

The Securities and Exchange Commission ("SEC" or "Commission") has recognized that, "[d]epending on a particular customer's situation and account objectives, the extent of trading alone may render transactions unsuitable. Hence, excessive trading represents an unsuitable frequency of trading and violates NASD suitability standards." In re Paul C. Kettler, 51 S.E.C. 30, 32 (1992); see also In re Michael H. Hume, Exchange Act Rel. No. 35608, at 4 n.5 (April 17, 1995); In re John M. Reynolds, 50 S.E.C. 805, 806 (1992). A representative may make only such recommendations -- or effect such transactions in cases where the representative controls the account -- as would be consistent with the customer's financial situation and needs. See In re Larry Ira Klein, Exchange Act Rel. No. 37835, at 10 (Oct. 17, 1996).

The first step in analyzing an action based on excessive trading is to determine whether the representative controlled the account. This element is satisfied if the account was discretionary, see In re Peter C. Bucchieri, Exchange Act Rel. No. 37218, 7 n.11 (May 14, 1996), or if the representative exercised de facto control over the account. De facto control of an account may be established where the client habitually followed the advice of the broker. See Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980); In re Gerald E. Donnelly, Exchange Act Rel. No. 36690, at 6 (Jan. 5, 1996); In re Michael H. Hume, Exchange Act Rel. No. 35608, at 6 n.11 (April 17, 1995).

Sisson exercised de facto control over both KP's and ED's accounts during the periods in question. As noted earlier, Sisson admitted that both customers habitually followed his recommendations and rarely took affirmative steps to direct the trading in their own accounts. In fact, the evidence shows that neither KP nor ED was sophisticated or experienced enough to evaluate effectively Sisson's complicated strategy of purchasing high-yield securities using margin.[5] The finding that Sisson controlled ED's account is bolstered by the fact that the trading activity in the account changed little when RD, a sophisticated and active investor, died.

The next step in analyzing a case based upon excessive trading is to determine whether the trading activity was in fact excessive. There is no single test for making such a determination. The "assessment of the level of trading . . . does not rest on any 'magical per annum percentage,' however calculated." Gerald E. Donnelly, supra, at 5. Nonetheless, factors such as the turnover ratio,[6] the cost-equity ratio,[7] the use of "in and out" trading,[8] and the number and frequency of trades in an account introduce some measure of objectivity or certainty into the analysis and provide a basis for a finding of excessive trading. See Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 (7th Cir. 1983); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 435-36 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970); In re John M. Reynolds, 50 S.E.C. 805, 808 n.12 (1992).

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[5] At the DBCC hearing, Sisson and RF both acknowledged that at some point between 1988 and 1992, KP became too ill to control the activity in her account, although they disagreed about when that occurred. Because we find that KP did not control her account at any time relevant to the complaint, it is unnecessary to decide when she became ill and what effect the illness had on her account.

[6] The turnover ratio is calculated by applying the "Looper formula," named after In re Looper & Co., 38 S.E.C. 294 (1958), which divides the total cost of purchases made during a given period by the average monthly investment. See In re Frederick C. Heller, 50 S.E.C. 275, 276-77 (1993). The turnover ratio is computed "by dividing the aggregate amount of the purchases by the average cumulative monthly investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." Id. at 279 n.10. A modified Looper formula divides the total cost of purchases by the average monthly equity. See In re Allen George Dartt, 48 S.E.C. 693 (1987); Report of the Special Study of the Options Markets to the Securities and Exchange Commission, H.R. Com. Print IFC3, 96th Cong., 1st Sess. (1978).

[7] This is sometimes expressed as the "break-even cost factor." The phrases refer to identical calculations. See In re Donald A. Roche, Exchange Act Rel. No. 38742 (June 17, 1997). This calculation represents the percentage of return on the customer's average net equity needed to pay broker/dealer commissions and other expenses, such as margin interest. Put another way, because of the transaction costs related to trading, the account would need to appreciate that amount to break even. See Frederick C. Heller, supra, at 276-77.

[8] The term "in and out" trading refers to the sale of all or part of a portfolio, with the money from the sale being reinvested in other securities, followed by the sale of the newly acquired securities. See Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).

Turnover rates between three and four, for instance, have triggered liability for excessive trading,[9] and the courts and the SEC have held that there is little question about the excessiveness of trading when the annual turnover rate in an account is greater than six.[10] Excessive trading also has been found in cases in which the cost-equity ratio was between 15 and 30 percent, or more.[11]

The trading in KP's and ED's accounts was excessive considering their financial needs and situations. KP was a retired, unsophisticated investor who lacked significant income, assets, or securities holdings other than that generated by or contained within her accounts with Sisson. The annualized turnover rate in KP's account was 3.82, and her account suffered realized and unrealized losses of $38,930 and paid commissions of $38,930.

Sisson claims that the heavy trading in KP's account was necessary to generate the additional income that KP requested in December 1988. The Commission has held that even where a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. See John M. Reynolds, supra, at 809 (representative was obligated to abstain from making recommendations that were inconsistent with their customer's financial situation); In re Gordon Scott Venters, 51 S.E.C. 292, 294-95 (1993) (same). Thus, Sisson's conduct is not excused simply because he acceded to his client's wishes. He was obligated to explore other avenues for generating income, or to explain to his

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9 In re Donald A. Roche, Exchange Act Rel. No. 38742 (June 17, 1997) (turnover rates of 3.3, 4.6 and 7.2 provided strong support for finding of churning); Gerald E. Donnelly, supra, at 4 n.11 (respondent acknowledged that "an annualized turnover rate of between two and four percent is presumptive of churning."); Michael H. Hume, supra, at 4 n.5 (turnover rates of 3.5 and 4.4 were found to be excessive in past cases); John M. Reynolds, supra, at 808 n.12 (1992) (finding excessive trading, in part, based on the fact that the account was turned over more than four times on an annualized basis); In re R.H. Johnson & Co., 36 S.E.C. 467, 469-80 (1955) (turnover rates of 3.26 to 11.1 annually found to be excessive).

10 See, e.g., In re Peter C. Bucchieri, Exchange Act Rel. No. 37218, at 7 (May 14, 1996) ("While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading.") (citing Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980); In re Shearson Lehman Hutton Inc., 49 S.E.C. 1119, 1122 (1989) (same).

11 See, e.g., Peter C. Bucchieri, supra, at 2-7 (finding that cost-equity ratio for accounts of 22.4 percent, 25.6 percent, 21.8 percent, and 24.9 percent supported finding of excessive trading); In re Thomas F. Bandyk, Exchange Act Rel. No. 35415 (Feb. 24, 1995) ("His excessive trading yielded an annualized commission to equity ratio ranging between 12.1% and 18.0%."); Frederick C. Heller, supra, at 277 (cost-equity ratio of 36 percent evidenced excessive trading); In re Michael David Sweeney, 50 S.E.C. 761, 763-65 (1991) (cost-equity ratios of 27 percent, 44 percent, 36 percent, and 22 percent indicated excessive trading).

client that his ability to generate income from her account was limited by an acceptable level of risk or cost.

Like KP, ED was a retired, unsophisticated investor who lacked significant income or securities holdings other than that generated by or contained within her accounts with Sisson. The turnover rate of 2.45 in ED's account has not, alone, been considered excessive. However, we find that a turnover rate of 2.45, when combined with a cost-equity ratio of .19 (to recover the commissions and interest paid to Portsmouth, ED's account would have needed to generate an annual return of 19 percent), is excessive. ED's account had losses of $112,190, and paid commissions of $52,008 during the period in question.

Sisson claims that his trading in ED's account was reasonable because it closely mirrored RD's investment strategy and was consistent with RD's objectives before his death. Sisson's claims, while supported by the record, are irrelevant. When RD died, Sisson should have shifted his focus from RD's objectives to ED's objectives and her financial situation as a surviving spouse. Sisson's continued heavy margin trading in ED's account was inconsistent with the reality of ED's inexperience and lack of sophistication. Sisson should have also considered that, with her husband's death, ED lost a potential source of income and that she might wish to alter her lifestyle. For these reasons, Sisson's defense must fail.

Finally, Sisson contends that he cared deeply about KP's and ED's welfare and that he acted with the best of intentions toward them. The evidence shows that Sisson was sincere in these claims. KP and ED were long-time clients of Sisson's, having maintained their accounts with him for more than a decade and through three different member firms. Sisson and Sisson's wife interacted socially with KP, and Sisson visited her regularly after she entered the retirement community. Sisson also consulted regularly with ED, and had been a trusted, patient advisor to RD for over a decade. There is, however, no scienter requirement under the NASD rules related to excessive trading. <u>See</u> <u>Erdos v. SEC</u>, 742 F.2d 507, 508 (9th Cir. 1984); <u>Frederick C. Heller</u>, <u>supra</u>, at 280. It is not necessary to find that Sisson acted with malice or intent toward his clients, in order to find that he traded excessively in their accounts.

Accordingly, we find that Sisson violated Conduct Rules 2110 and 2310 by making recommendations that were unsuitable with respect to size and frequency in light of KP's and ED's financial situations and needs.

<u>Sanctions</u>

The NASD Sanction Guideline ("Guideline") applicable to Sisson's violation, entitled "Suitability," suggests fining away all commissions to the respondent, plus $5,000 to $25,000.[12] In cases involving numerous recommendations of clearly unsuitable securities and no prior similar misconduct, the Guideline suggests suspending the respondent in all capacities for 10 to 30 business days and requiring requalification by examination.

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12 <u>See</u> NASD Sanction Guidelines (1993 ed.) at 43 (Suitability)

The principal considerations for determining where, in the range of available sanctions, Sisson's conduct falls are: (1) prior or other similar misconduct; (2) amount of commission or other benefits to respondent; (3) extent of harm or injury to customers; (4) number of unsuitable recommendations involved; (5) attempts to conceal misconduct by misstating customer information; (6) honest misunderstanding of the customers' financial resources, other security holdings, and investment objectives; (7) investment experience, sophistication, and resources of customers(s); (8) prompt and voluntary restitution by the respondent; and (9) other mitigating or aggravating factors.

This case was called for review to evaluate whether the sanctions imposed on Sisson were too lenient. The DBCC ordered that Sisson be censured, fined $15,000, suspended in all capacities for 10 business days, required to requalify as a general securities representative prior to becoming reassociated with a member firm, and assessed $943 in costs.

These sanctions are inadequate considering: (1) the large number of unsuitable recommendations that Sisson made; (2) the high commissions the clients paid; (3) the extent of injury to KP and ED; (4) Sisson's failure to make restitution; and (5) KP's and ED's lack of experience and sophistication. These factors confirm that Sisson's violations were serious and justify higher sanctions in this case. We will increase Sisson's fine to $35,000, consisting of $15,000 as a remedial fine and $20,000 in commissions that he collected from the two accounts.

Accordingly, we order that Sisson be censured, fined $35,000, suspended in all capacities for 10 business days, required to requalify by examination as a general securities representative within 120 days following completion of his suspension and prior to re-associating with any member firm, and assessed DBCC costs of $943.90. The suspension will take effect on a date to be determined by the President of NASD Regulation.[13]

On Behalf of the National Adjudicatory Council,

Alden S. Adkins,
Senior Vice President and General Counsel

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[13] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

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