BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

| | |
|---|---|
| In the Matter of<br><br>Department of Enforcement,<br><br>Complainant,<br><br>vs.<br><br>James B. Chase<br>Milwaukee, WI,<br><br>Respondent. | DECISION<br><br>Complaint No. C8A990081<br><br>Dated: August 15, 2001 |

**Registered representative made unsuitable recommendations to his customer. Held, Hearing Panel's findings affirmed in part and sanctions affirmed in part and modified in part.**

Respondent James B. Chase ("Chase") appealed the September 25, 2000 decision of a Hearing Panel pursuant to NASD Procedural Rule 9310. After a review of the entire record in this matter, we affirm the Hearing Panel's findings that Chase violated NASD Conduct Rules 2110 and 2310 by recommending and effecting transactions in customer YH's account without a reasonable basis to believe that such recommendations were suitable for YH. We order that Chase be suspended from association with any NASD member in any capacity for one year, fined $25,000, and ordered to requalify by examination as a general securities representative before re-entering the industry.

Background

Chase first became an associated person in 1969.[1] From May 1995 through December 1997, Chase was registered as a general securities representative and a general securities principal with Collopy & Co., Inc. ("Collopy"), a member of the NASD. Chase was

[1] Chase is no longer employed in the industry.

the President, Secretary, Treasurer, and sole owner of Collopy. Chase left Collopy voluntarily in December 1997, and he is no longer associated with a member firm.[2]

The complaint charged that, between December 1995 and February 1997, Chase made unsuitable recommendations to his customer, YH, when he recommended approximately 102 purchases of the common stock of the Female Health Company ("FHC") for YH's two accounts, one of which was a margin account.[3]

Facts

In 1994, YH was a 24-year-old unmarried college student who lived with her mother in her mother's condominium. In July 1994, YH received securities valued at approximately $540,000 as part of a court settlement. Those securities represented essentially all of YH's assets. According to her tax returns, YH's adjusted gross income for 1994 was $6,900.

After the court settlement, YH's attorney referred her to Chase to help her manage and invest her assets. YH and her attorney met with Chase several times before YH opened a cash account in September 1994 at Megarian, Inc. ("Megarian"), with which Chase was associated at that time. YH's new account form at Megarian indicated that her investment objective was "income," that she preferred "low" risk exposure, and that she had "zero" investment experience. YH opened the account with the proceeds from the court settlement, which, after attorney's fees, were approximately $436,000 cash.

Chase initially invested YH's funds in a portfolio of asset-backed securities, US Treasury securities, other U.S. government and corporate bonds, preferred stocks, and various limited partnerships. From September 1994 through January 1995, YH withdrew approximately $19,000 from her account for personal expenses. YH continued making monthly withdrawals of several thousand dollars from her account for personal expenses throughout 1995.[4] According to Chase, YH's lawyer and accountant received duplicate confirmation forms from YH's account.

---

[2] Chase remains subject to the jurisdiction of NASD Regulation, Inc. ("NASD Regulation") for purposes of this proceeding pursuant to Article V, Section 4(a) of the NASD By-Laws, which prescribes a two-year period during which NASD Regulation retains jurisdiction for conduct occurring prior to termination.

[3] YH brought an arbitration action against Chase to recover her losses. She agreed to settle the case for $14,000.

[4] Chase left Megarian and became associated with Collopy on May 30, 1995. YH's account was transferred to Collopy in June 1995.

At some point in 1995, Chase urged YH to curb her withdrawals from the account. He explained to her that if the withdrawals continued, they would have to change the account objective from "income" to another category that would allow investment in securities that promised a greater return. Chase testified that he believed that YH and her attorney had agreed to change her primary account objective from "income" to "growth." YH's account forms reflect that her investment objectives were changed to "growth" and "speculation."

Chase's Recommendations to Purchase FHC. FHC was established in 1994 and began trading publicly for the first time in January 1995. At that time, FHC's sole product, a female condom, was new and had no established or tested market. FHC did not have an operating profit, and its stock was thinly traded on the American Stock Exchange. Chase admitted that in 1995 and 1996, he considered FHC to be a speculative investment.

Around February 1996, Chase agreed to serve as a placement agent for FHC. Under the terms of his agreement with FHC, Chase would receive compensation in the form of warrants to purchase 200,000 FHC shares at a discount if he could arrange a certain number of private placements with institutional investors. In April 1996, Chase received 60,000 shares of FHC as compensation for the placement of 450,000 shares with institutional investors. In a separate agreement at about the same time, FHC also retained Chase to raise an additional $5,000,000 in funding through private placements with institutional investors. Had Chase been able to make those placements, he would have earned an additional 36,000 shares of FHC. Chase's sale of FHC stock to YH was not part of these agreements. There is no evidence that Chase received any compensation from FHC for selling FHC shares to YH, nor that Chase sold FHC shares to YH out of any inventory that he controlled.

On Chase's recommendation, YH began purchasing FHC in February 1996. YH continued to purchase FHC on Chase's recommendation regularly throughout 1996. The growing concentration of FHC stock in YH's account did not deter Chase, who continued to recommend that YH purchase FHC until FHC represented 100 percent of YH's equity investments. YH was able to fund these purchases of FHC by selling her other securities.

Chase prepared another new account form for YH in March 1996. This account form listed her net worth as $800,000, her liquid assets as $500,000, and her investment objectives, in order of priority, as "growth," "speculation," "income," and "safety." When asked where he had obtained the new "net worth" figure, Chase testified that YH had purchased a $250,000 condominium in December 1995. Chase estimated that the condominium had increased in value to $300,000, thus accounting for the increase of $300,000 from the net worth reported on YH's first new account statement.[5] As for the "liquid assets" figure, YH's brokerage account statement for March 1996 listed her total assets in the account as approximately $309,000.

---

5 Chase did not state the basis for his assumption that the value of YH's condominium had increased by 20 percent in just three months.

Chase did not testify about how he had factored the additional $191,000 into the total, and there is no evidence that YH had any liquid assets apart from those held in her account. A subsequent new account form in July 1996 listed substantially the same information and stated that YH's tax bracket was "30%." YH's tax return for 1995, however, indicated that her adjusted gross income for that year was just $20,362, below the threshold income level that was taxed at 30 percent.

YH's Margin Account. In May 1996, Chase recommended that YH open a margin account to enable her to purchase more shares of FHC. YH's May 1996 monthly statement indicated that, other than the FHC stock, the only other holding in her account was approximately $1,817 in a money market fund. The May 1996 monthly statement also indicated that YH's net account value (including the margin debit balance) was about $455,900. In a letter dated May 13, 1996, Chase acknowledged that YH had signed the margin agreement and stated, "As I mentioned we will use the borrowed funds to hold the larger FHC position. PaineWebber charges 8.375% on its margin accounts. We believe the potential gain on the position justifies this increased cost.'[6]

After opening the margin account, and encouraged by Chase's ongoing recommendations, YH continued to purchase FHC in her margin account. YH's monthly margin balance throughout 1996 ranged from $43,000 to more than $195,000, and prompted interest payments of more than $9,500 that year. FHC represented 100 percent of YH's holdings from May 1996 through February 1997,[7] when, because of FHC's declining share price, the value of the securities in YH's account fell to approximately $188,000 and the margin balance was almost $84,000. Thus, the net equity in YH's account (including approximately $198,000 that YH withdrew between September 1994 and February 1997) fell from $455,900 to approximately $104,110 in just nine months. Because YH's only holding was FHC, she was forced to meet the margin calls by selling the rapidly declining stock that was triggering the calls in the first place.

Chase's Understanding of His Obligations to Customers. Chase insisted during the proceedings below that his "primary responsibility is to make sure that the customer is fully advised of all the facts and can make intelligent decisions." He argued that he was always careful to inform YH of the risks and potential benefits of his recommendations. Chase stated that he made these same disclosures with regard to the concentration of FHC in YH’s account,

---

6 During his testimony before the Hearing Panel, Chase initially testified that YH opened a margin account in order to fund the purchase of her condominium, and not to buy more FHC. He later admitted, however, that "[s]he ha[d] a margin account to buy some additional shares of FHC."

7 We note one exception: in September 1996, FHC represented 91 percent of the account's value.

although he continued to recommend the purchase of FHC stock, even as the concentration of FHC in YH's account increased.

Chase believed that concentration in just one or two stocks could be a sound investment strategy. During the proceedings below, he stated:

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

Chase testified that although he did not specifically recommend that YH reach 100 percent concentration in FHC, he did not suggest that she reduce her concentration or diversify her portfolio. Nor did Chase cease recommending the purchase of FHC after the concentration in YH's account reached 100 percent.

Enforcement initiated these proceedings on December 7, 1999. On September 25, 2000, the Hearing Panel issued its decision, finding that Chase had made unsuitable recommendations to YH in violation of Conduct Rules 2110 and 2310. Specifically, the Hearing Panel found unsuitable Chase's recommendations that: (1) YH change her investment objectives, (2) YH purchase FHC until the concentration in her account reached "undue levels," and (3) YH use a margin account to purchase still more shares of FHC. The Hearing Panel suspended Chase from associating with any NASD member in any capacity for six months, fined Chase $25,000, and ordered that Chase requalify by examination as a general securities representative within six months of the date of the decision or before he re-enters the business.

<u>Discussion</u>

On appeal, Chase argued that because YH changed her investment objectives from "income" to "growth" and "speculation," Chase's recommendations to purchase FHC--even to the point that FHC comprised her entire portfolio--were suitable. He also argued that YH's use of a margin account to leverage her FHC holdings to purchase still more FHC shares was suitable. We have reviewed the evidence and the parties' arguments, and we affirm the Hearing Panel's findings that Chase violated NASD Conduct Rules 2110 and 2310 when he made 102 recommendations to YH to purchase shares of FHC, concentrating her entire portfolio in this single high-risk stock, and when he recommended that YH open a margin account to allow her to purchase even more FHC stock.

<u>YH's Changed Investment Objectives.</u> YH submitted an affidavit below in which she averred that she had never changed her investment objectives, that Chase had tried to force her to choose between discontinuing her withdrawals or changing her investment objectives, and

that Chase changed the investment objectives on her new account form without her permission. The Hearing Panel admitted the affidavit into evidence and, relying on the affidavit, found that YH had not changed her investment objectives.

Chase moved, both before the Hearing Panel and on appeal, to exclude the affidavit (part of which had been redacted) on the ground that it lacked sufficient indicia of reliability. In his brief on appeal, Chase argued that the Hearing Panel had improperly relied on YH's affidavit in finding that YH had not changed her investment objectives. Chase argued that because, among other things, the affidavit was partially redacted, the Hearing Panel could not have made a proper determination of its reliability. For this reason, a subcommittee of the National Adjudicatory Council ("NAC") admitted the entire unredacted affidavit, but stated that it would consider the parties' arguments about the affidavit's reliability during its deliberations on the matter.

It is well settled that hearsay evidence is admissible in the proceedings of self-regulatory organizations, and, if certain reliability factors are satisfied, it can actually "form the basis for findings of fact" in Hearing Panel decisions. <u>Charles D. Tom</u>, Exchange Act Rel. No. 31081 (Aug. 24, 1992). According to the SEC, the following factors must be considered: possible bias of the declarant; the type of hearsay involved; whether the statements are signed and sworn to rather than anonymous, oral or unsworn; whether the statements are contradicted by direct testimony; whether the declarant was available to testify; and whether the hearsay is corroborated. <u>Id.</u> We note, however, that the Hearing Panel's decision did not analyze the reliability of the affidavit, but rather stated, without explanation or analysis, that it found "YH's affidavit to be the more credible evidence [as between the affidavit and Chase's testimony before the Hearing Panel] as to YH's investment objectives."

Because the Hearing Panel did not engage in any analysis of the affidavit's reliability, we do not affirm the Hearing Panel's finding that the affidavit established that YH did not change her investment objectives. However, we conclude that the evidence offered in the affidavit is unnecessary to our findings of violation of the NASD Conduct Rules. Regardless of whether YH changed her investment objectives, there are bases for finding that Chase's conduct constituted violations of Rules 2310 and 2110.[8]

<u>Chase's Suitability Obligation.</u> NASD Conduct Rule 2310, also known as the "suitability" rule, requires a broker, in recommending a security to a customer, to have reasonable grounds for believing that the security is an appropriate investment for that customer, based on the customer's financial situation and needs.

---

[8] Because there is a sufficient basis for finding violations, we do not need to decide whether the affidavit should have been admitted.

The NASD's suitability rule can be violated in a number of ways.[9] It is important to emphasize, however, that the rule applies only to securities that the broker "recommends" to customers. See Thomas E. Warren, III, 51 S.E.C. 1015, 1019 n.19 (1994) (holding that suitability claims were not supported because record contained "no evidence that Warren recommended the transactions that were effected in these accounts"), aff'd, 69 F.3d 549 (10th Cir. 1995) (table format); Sales Practice Requirements for Certain Low-Priced Securities, Exchange Act Rel. No. 27160, 54 Fed. Reg. 35468, 35476-35477 (Aug. 22, 1989) ("[T]he NASD and other suitability rules have long applied only to 'recommended' transactions."). Merely effecting a trade at a customer's request does not trigger the suitability rule. See Members' Suitability Obligations, 1996 NASD Notice to Members 96-60, 1996 NASD LEXIS 76, at *3 (stating that a member's suitability obligation does not apply "to situations in which a member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member").

The Hearing Panel correctly found that Chase recommended that YH purchase FHC for her account. Chase admitted during the proceedings below that, although YH's order tickets had been marked "unsolicited," he had recommended the stock before each purchase. Chase therefore had an obligation to determine that the purchase of FHC was suitable for YH, given her financial situation and needs.[10]

Chase demonstrated a profound lack of understanding of his customer-specific suitability obligation under Rule 2310. Chase's attorney argued during the proceedings below

---

[9] Most often, a broker violates the suitability rule by recommending to a customer a security that might be suitable for some investors, but that is unsuitable for that particular customer. F.J. Kaufman and Co., 50 S.E.C. 164, 167 (1989). A broker also must have a reasonable basis "to believe that the recommendation could be suitable for at least some customers." Id. at 168 (emphasis in original). This is called "reasonable basis" suitability, and it "relates only to the particular recommendation, rather than to any particular customer." Id. In addition, a broker has a "quantitative" suitability obligation, which prohibits the broker from engaging in an inappropriate frequency of trades, often referred to as excessive trading or churning. A broker could violate the suitability rule, for example, where he or she recommended to a customer an excessive (and based on the customer's financial situation and needs, an inappropriate) number of securities transactions and the customer routinely followed the broker's recommendations. See, e.g., Harry Gliksman, Exchange Act Rel. No. 42255, at 4 (Dec. 20, 1999) ("Under [Rule 2310], recommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."); Rafael Pinchas, Exchange Act Rel. No. 41816, at 11-12 (Sept. 1, 1999) ("[E]xcessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading.")

[10] Because we find that Chase could have had a reasonable basis for believing that FHC was suitable for at least some investors, we will analyze whether Chase fulfilled his customer-specific suitability obligation.

that Chase's "primary responsibility [was] to make sure that the customer [was] fully advised of all the facts and [could] make intelligent decisions." Again, during the hearing on appeal, Chase's attorney argued that Chase had fulfilled his suitability obligation by disclosing to YH the risks associated with following his recommendations to purchase FHC and to open a margin account. Although it is important for a broker to educate clients about the risks associated with a particular recommendation, the suitability rule requires more from a broker than mere risk disclosure. See Patrick G. Keel, 51 S.E.C. 282, 286 (1993) (noting that a broker must ensure that the customer understands the risks involved in a recommended securities transaction, in addition to determining that the recommendation is suitable for the customer).

Chase argued that his recommendations of FHC, which he admitted was a speculative stock, were suitable in light of YH's change in her stated investment objectives from "income" to "growth" and "speculation." A customer's investment objectives, however, are but one factor to consider in determining whether the broker's recommendations were suitable for the customer. Furthermore, a broker cannot rely upon a customer's investment objectives to justify a series of unsuitable recommendations that may comport with the customer's stated investment objectives but are nonetheless not suitable for the customer, given the customer's financial profile. Thus, even where a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a broker has a duty to refrain from making recommendations that are incompatible with the customer's financial situation and needs. See, e.g., John M. Reynolds, 50 S.E.C. 805, 809 (1992) (stating that regardless of whether the customer wanted to engage in aggressive and speculative trading, the broker was obligated to abstain from making recommendations that were inconsistent with the customer's financial situation); Paul F. Wickswat, 50 S.E.C. 785, 786-87 (1991) ("The proper inquiry is not whether [the customer] viewed [the broker's] recommendations as suitable, but whether [the broker] fulfilled his obligation to his client."). Chase's recommendations therefore were not automatically made suitable by the alleged change in YH's investment objectives, when YH's financial situation and needs remained unchanged.[11]

We also find that contrary to Chase's assertion that concentration in one or two speculative stocks can be a sound investment strategy, and regardless of YH's alleged change in investment objectives, Chase's recommendations to purchase FHC shares until it was the only stock in YH's entire portfolio were unsuitable. See, e.g., Clinton H. Holland, Jr., 52 S.E.C. 562, 566 (1995) ("The concentration of high risk and speculative securities [in the customer's] account . . . was not suitable."), aff'd 105 F.3d 665 (9th Cir. 1997) (table format); Daniel R. Howard, No. C11970032, 2000 NASD Discip. LEXIS 16, at *19 (NASD Nov. 16, 2000) ("Howard's recommendations also led to an undue concentration of these speculative securities

[11] We do not suggest that it would have been improper, given YH's monthly withdrawals, for Chase to suggest placing some smaller portion of her assets into securities that had the potential to generate greater returns. It was unsuitable, however, for Chase to recommend the purchase of FHC until it comprised the only holding in her account.

[approximately 90 percent of the customer's holdings], making the recommendations particularly unsuitable."). YH required a more conservative investment strategy. Her account contained virtually all of her liquid assets. FHC was a company that sold a sole, untested product, and its stock was therefore highly speculative. We find that Chase's recommendations, which led to an overconcentration of FHC, were patently unsuitable.

Chase argued that because YH was studying economics in college and was able to download information about FHC off of the Internet, she had sufficient knowledge to evaluate the suitability of the investment for herself. A college economics course and access to information do not, however, constitute "investment experience" or "sophistication." Cf., Peter C. Bucchieri, 52 S.E.C. 800, 805 n.9 (1996) (noting that customer's graduate degree from Harvard did not make him a sophisticated investor).

Nor do we find that Chase should be absolved of responsibility for his recommendations because YH's mother, accountant, and attorney were all allegedly involved in YH's financial planning and received duplicate confirmation forms. There is no evidence that these three people had any investment knowledge or experience,[12] nor do we know the extent to which they participated in the management of her affairs. Even if they did, Chase would in no way be relieved of his suitability obligation. As a licensed securities professional, Chase had a duty to recommend only suitable investments to YH. The fact that YH's mother, attorney and accountant, who were neither Chase's clients nor licensed securities professionals, may have received information about the purchases that Chase made for YH's account does not reduce, alter, or relieve Chase from his suitability obligation.

The purchase of additional shares of FHC on margin compounded the problem of overconcentration of FHC in YH's cash account. The shares of FHC that were held in YH's cash account secured Collopy's margin loan to her. This cash account represented YH's entire liquid net worth, and after she purchased more FHC shares on margin at Chase's recommendation, she had invested more than her entire liquid net worth in one speculative stock. Although Chase testified several times that YH opened the margin account to fund the purchase of a condominium, his letter to YH dated May 13, 1996 made clear that he had mentioned to her that the purpose of the margin account was to allow her to purchase still more FHC shares. This letter also made clear that he believed that the use of margin to purchase more FHC shares was a wise investment strategy. The letter does not mention any of the risks associated with the use of margin.

We find unsuitable Chase's recommendation that YH use a margin account to purchase still more shares of FHC. Chase should have realized that because the account represented all

---

[12] Chase argued below that because YH's attorney held a substantial amount of money in his own securities accounts, he was a sophisticated investor whose involvement in YH's account should have absolved Chase of responsibility. We have no evidence, however, of what YH's attorney knew about investing.

of YH's liquid assets, she would have to pay any margin calls by liquidating shares of FHC. YH's interest payments would similarly require liquidation from YH's FHC holdings.

In sum, we find that the evidence clearly supports the Hearing Panel's finding that Chase did not have a reasonable basis for recommending that YH purchase FHC until it represented 100 percent of her holdings or for recommending that YH open a margin account to purchase still more FHC stock. We therefore affirm the Hearing Panel's findings that such conduct constituted a violation of Conduct Rules 2110 and 2310.

Sanctions

The Hearing Panel ordered that Chase be suspended from association with any NASD member in any capacity for six months, fined $25,000, and ordered to requalify by examination as a general securities representative before re-entering the industry.

We note that the 1998 edition of the NASD Sanction Guideline ("Guideline") for suitability violations recommends a fine in the range of $2,500 to $50,000, plus the amount of any profits to the respondent, and requalification by examination.[13] The Guideline also recommends a suspension in all capacities for 10 to 30 business days, in cases involving numerous unsuitable recommendations and no prior similar misconduct and a longer suspension or bar in egregious cases.

We find that the Hearing Panel's fine and requirement to requalify are appropriately remedial and consistent with the Guideline, but we believe that the egregious conduct at issue here warrants an increase in the suspension from six months to one year.[14] We are troubled that Chase demonstrated a complete lack of understanding of his suitability obligation. Rather than recommending the investment of some of YH's assets in a growth stock to generate a greater return in light of her monthly withdrawals, Chase recommended that she purchase FHC, a risky stock issued by a company with no operating history or profits, until it comprised 100 percent of her portfolio. Chase also recommended the use of a margin account to purchase still more FHC stock, until she held more in FHC shares than her entire liquid net worth. Chase testified

---

[13] The recommended sanctions are consistent with the applicable NASD Sanction Guidelines ("Guidelines"). See Guidelines (1998 ed.) at 83 (Suitability). Enforcement presented no evidence of the commissions that Chase earned. YH, however, was compensated for her losses through arbitration.

[14] Chase has prior disciplinary history of recommending unsuitable transactions. In 1991, the state of Wisconsin censured Chase for making unsuitable recommendations to a Wisconsin resident to purchase securities in an oil and gas company that filed for bankruptcy in 1989. Similarly, in 1995, the New York Stock Exchange ("NYSE") censured Chase for, among other things, recommending unsuitable transactions to a customer.

that he believed his only responsibility to his clients was risk disclosure. This belief was erroneous. As explained above, regardless of the course the customer wants to take, a registered representative has a duty to refrain from making recommendations that are unsuitable for a customer, based on that customer's financial situation and needs.

We believe that the $25,000 fine, the one-year suspension and the requalification requirement are appropriate given the nature of the violation and these aggravating factors. Therefore, we order that Chase be fined $25,000, suspended for one year from association with any NASD member, and required to requalify as a general securities representative by examination before reentering the industry.

Accordingly, Chase is suspended from association with any NASD member in any capacity for one year, fined $25,000, and required to requalify as a general securities representative before re-entering the industry.[15]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

---

[15] 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. The sanctions that we have imposed are consistent with the applicable NASD Sanction Guideline.

Pursuant to NASD Procedural Rule 8320, any member that 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.