NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. ROGER P. MAY (CRD No. 717728) Respondent.	Disciplinary Proceeding No. C3A030050 Hearing Officer – SNB **HEARING PANEL DECISION** May 11, 2005

Respondent (1) made unsuitable recommendations to a customer, in violation of NASD Conduct Rules 2310 and 2110; and (2) engaged in unauthorized transactions, in violation of Rule 2110. For making unsuitable recommendations, Respondent is fined $5,000, ordered to make restitution in the amount of $91,158 and suspended in all capacities for three months. For engaging in unauthorized transactions, Respondent is fined $25,000 and suspended in all capacities for one year. Enforcement failed to prove by a preponderance of the evidence that Respondent omitted to disclose material information in violation of Section 10(b) of the Securities Exchange Act of 1934, Securities Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110, and, accordingly, that charge is dismissed.

Appearances

Jacqueline D. Whelan, Esq. and Helen G. Barnhill, Esq., Denver, CO (Rory C. Flynn, Esq., Washington, DC, of Counsel), for Complainant.

Thomas D. Birge, Esq., Denver, CO, for Respondent.

DECISION

I. Procedural History

On December 16, 2003, the Department of Enforcement filed a Complaint charging that Respondent Roger P. May ("May") (1) omitted to disclose to customers material information in connection with his recommendations to purchase securities in

PentaStar Communications, Inc. ("PentaStar"); (2) made unsuitable recommendations to purchase PentaStar; and (3) engaged in four unauthorized purchases of PentaStar in a customer account. May filed an Answer denying the charges and requesting a hearing, which was held in Denver, Colorado on September 9 and 10, 2004, before a Hearing Panel that included a Hearing Officer and two members of the District 3 Committee.[1] The Department of Enforcement called six customers, SF, ER, ST, RI, RS, and CJ, and one NASD staff member, Donald K. Lopezi.[2] May testified on his own behalf, and called Thomas J. O'Rourke, who served as the President of Schneider Securities, Inc. ("Schneider") during the period at issue in this case.

II. Facts

A. Respondent

May has been in the securities industry since 1980. May was registered with Schneider from April 1985 until September 2002, when Schneider ceased conducting a securities business. He is presently associated with an NASD member firm as a general securities representative and principal. He has no prior disciplinary history. (CX-1; Tr. at p. 150)

B. PentaStar

PentaStar was formed in March 1999 and was a telecommunications sales agent. PentaStar's business strategy was to consolidate diverse sales agencies into a national sales agency. (CX-6A at p. 8; Tr. at pp. 165, 171, 181-182)

[1] Enforcement offered Complainant's Exhibits ("CX") 1-46, which were admitted without objection. May offered Respondent's Exhibits ("RX") 1-78, which were admitted without objection. Citations to the Hearing transcript are cited as "Tr. at p."

[2] SF testified by telephone.

From its October 1999 IPO at $10, PentaStar generally appreciated to over $20 per share until August 14, 2001, when PentaStar announced a loan default with its primary lender, and a decline in revenues. (RX-61; CX-6G at pp. 12 and 19)[3]

A month and a half later, on October 1, 2001, PentaStar announced that it had restructured its credit agreements, extending the term until April 5, 2002; eliminating the financial covenant ratios with which PentaStar was in non-compliance; providing PentaStar with borrowing capacity up to $7.5 million; and providing it with immediate cash for operations. PentaStar also announced that it was experiencing positive cash flow because of its restructuring, and that it expected third quarter results to be substantially improved versus second quarter results. (CX-5 at p. 42)

However, on December 3, 2001, PentaStar announced that, as of March 1, 2002, it would no longer be an authorized agent for Verizon Communications, a significant source of PentaStar's revenue.[4] (CX-5 at p. 25)

On March 11, 2002, PentaStar announced that it was unable to meet its current obligations, including payroll and debt service, it was in default under its credit agreements, and its lenders had refused to advance additional funds. Following this announcement, PentaStar's stock price dropped from $2.05 per share to $.42 per share. Trading in PentaStar was halted on the Nasdaq Stock Market on April 1, 2002, and PentaStar later went out of business. (CX-5 at p. 9, CX-7J at p. 21)

[3] The stock price declined from $18.50 to $14.90 in the week following this announcement. (Complaint at para. 4; Answer at para. 4)

[4] PentaStar's stock price was $5.67 by the end of that week, 34% below its price earlier in the week, just prior to the announcement. (Complaint at para. 8; the Answer does not deny this allegation, so it is deemed admitted pursuant to Rule 9215(b))

C. May's PentaStar Recommendations

May was very familiar with PentaStar, and maintained contact with PentaStar's management, including PentaStar's Chief Executive Officer, throughout the time period relevant to the Complaint. In fact, May introduced Schneider's investment bankers to PentaStar management and Schneider later underwrote PentaStar's initial public offering. Schneider was also the leading market maker in PentaStar stock in terms of share volume from January 2001 through March 2002, and provided research on PentaStar. (CX-8; Tr. at pp. 69-72)

May believed in PentaStar's business plan – to consolidate telecommunications sales agencies into a national sales agency. He observed that telecommunications companies had high margins on additional revenues because the industry was overbuilt, indicating that a consolidation strategy could be successful. May also drew on his own experience with Schneider's telecommunications agent. May observed that Schneider was very loyal to its agent, who it had relied upon for 15 years to steer the firm in the right direction as to telecommunications services. May observed that telecommunication agents existed throughout the country, and noted that Schneider was a $50,000 per month telecommunications customer. May also knew and had confidence in PentaStar's management, who had a history of consolidating companies and working in the telecommunications market. (Tr. at pp. 170-197)

On August 14, 2001, when PentaStar announced its second quarter results and a loan default, May contacted PentaStar management. Management explained that the loan had a 75% debt to receivables limit, and PentaStar had exceeded that limit by a percentage point, which resulted in a technical default. May was further informed that the lender was "more than happy" to work out another credit agreement. Consistent with

this, on August 31, 2001, PentaStar announced that it had received a waiver of the default and extension of the loan maturity until September 30, 2001, during which time the loan was to be renegotiated.

On October 1, 2001, PentaStar announced that it had renegotiated the loan, it was experiencing positive cash flow and expected third quarter results to be substantially improved. Moreover, as part of the restructure, PentaStar management invested $200,000 of personal funds in PentaStar. May saw this as a vote of confidence for the future of PentaStar. May's views were reinforced by PentaStar's October 4, 2001 announcement that an investor group had invested $500,000 in PentaStar. Moreover, on November 14, 2001, PentaStar announced improved revenues and positive earnings of $12,000 before interest, taxes, depreciation and amortization ("EBITDA") for the third quarter, as compared with negative EBITDA for the prior quarter. Throughout this period, May believed that lower prices for PentaStar stock represented greater opportunity. (Tr. at pp. 174-186; CX-5)

On December 3, 2001, when PentaStar announced losing Verizon as a customer, May saw this as near term negative news, but not "a death sentence." He reasoned that when the Verizon contract expired in March 2002, PentaStar's sales agents could sell services for MCI, AT&T, Time Warner or other telecommunications companies, perhaps at the same or lower prices than those offered by Verizon. May also believed that PentaStar would be an attractive acquisition target, due to compression in the telecommunications industry and the revenues that PentaStar sales agents and their customers represented. (Tr. at pp. 174-190)

May continued to believe that the price drop in PentaStar's stock represented an opportunity. Consistent with this, May continued to recommend the purchase of

PentaStar throughout the time period relevant to the Complaint. May also purchased PentaStar for his own account, ultimately losing several hundred thousand dollars. (Tr. at p. 191) There is no evidence that May recommended PentaStar in order to generate commissions; his total commissions for the PentaStar purchases in his customers' accounts were approximately $5,000. (CX-11)

PentaStar's March 11, 2002 announcement, signaling that it was going out of business, came on the eve of the due date for PentaStar's Form 10-K. The announcement came as a total shock to May, as well as to the private investor group who had invested $500,000 in a PentaStar private placement six months earlier. (Tr. at pp. 194-198)

D. <u>The Customers</u>

It is undisputed that the customers at issue were generally professionals or business owners with substantial assets and large annual incomes who could afford to be aggressive with a portion of their portfolios. (Complainant's Brief at p. 2; Respondent's Brief at p. 3) It is also undisputed that some of the customers at issue in this case previously followed May's recommendation in the mid-1990's to accumulate large positions in Laser Vision Centers, which generally resulted in significant profits to these customers. (Complainant's Brief at p. 2, Respondent's Brief at p. 1)

Customers ER, ST, and RI testified at the Hearing as to the charges of material omissions of fact and unsuitable recommendations. Customer RS testified only as to the unsuitable recommendation charge, and customer WF testified only as to the unauthorized trading charge. Customer CJ did not testify.[5]

[5] Customer CJ was originally scheduled to testify as to the unsuitable recommendation charge, but he did not appear at the Hearing. However, a letter written by CJ addressed to May was introduced as evidence at the Hearing. (CX-36)

1. Customer ER's Account (allegations of material omissions and unsuitable recommendations)

Customer ER was employed by a real estate company and held a broker's license. (Tr. at p. 50) As indicated on his account opening form, he had over $1 million in net worth, over $100,000 in annual income (CX-26), and a liquid net worth of $1.1 million.[6] (Tr. at p. 76) ER's original broker was his father-in-law, who later turned the account over to May. (Tr. at pp. 39, 54) His account opening form at Schneider indicated that ER's investment objective, as a percent of available assets, was 50% - "aggressive growth." ER also indicated his risk tolerance was 50% - "high risk." (CX-26)

ER was an experienced investor. In addition to his account at Schneider, ER had four accounts with other brokerage firms, and at least five or six years' experience with margin accounts prior to opening his account at Schneider. (Tr. at pp. 53, 59, 76) ER estimates that he made "a couple hundred thousand dollars" trading in his prior margin account. (Tr. at p. 54)

It is undisputed that May recommended PentaStar to ER. (Tr. at pp. 56, 254, 256) At the time of ER's original investment in PentaStar, ER gave May price and time discretion to purchase PentaStar, as well as three other securities. (Tr. at p. 56) ER continued to purchase PentaStar at May's recommendation throughout 2001 and into

[6] While ER's account opening form disclosed liquid net worth of $75,000, he told the NASD staff that he had liquid net worth of $1.1 million. (Tr. at pp. 40, 53, 56, 57, 59, 75; CX-26) The Panel's finding is consistent with the information provided to the NASD staff, particularly given that ER deposited over $200,000 in his Schneider account, and he held four other brokerage accounts. ER was evasive when asked about the value of his other brokerage accounts. (Tr. at p. 59)

early 2002.[7] (RX-77) May mailed PentaStar press releases to ER, and discussed them with him.[8] (Tr. at p. 62) In the Fall of 2001, after the price of PentaStar had dropped, May told ER that he thought the price had overreacted and the reasons to own the stock were still in place. May told ER that he believed the stock price would bounce back. May believed that the investment objectives and risk tolerance information reflected on ER's account opening form were generally consistent with May's understanding, and he believed that the loss of the investment in PentaStar would not impact ER's lifestyle. (Tr. at pp. 257-258)

ER invested approximately $111,000 in PentaStar during the period alleged in the Complaint - August 2001 through February 2002. ER lost approximately $106,000 of this investment when PentaStar went out of business. (RX-77; Stipulation 9; CX-16; Stipulation 10)

[7] ER initially testified that May made PentaStar purchases in ER's account without ER's authorization. (Tr. at pp. 43-46). However, when ER was later confronted with account statements reflecting his deposits for the exact amount of the purchases on the same day that the purchases occurred, ER recanted his testimony and acknowledged that he did, or probably did, speak with May before each transaction. (Tr. at pp. 58-61) The Panel found ER's initial assertions that he did not discuss PentaStar investments to lack credibility, and instead found that ER authorized all transactions in PentaStar.

[8] ER initially testified that he and May never discussed PentaStar's August and December 2001 adverse press announcements. (Tr. at pp. 43-46.) ER also testified that he never received any PentaStar press releases. He later recanted this, acknowledging that he received at least one press release when he first purchased PentaStar, and while this was the only press release he could find in his records, he may have received others. (Tr. at pp. 59, 62-65) He also acknowledged that he may have discussed with May PentaStar's adverse press releases and why the price of the stock was dropping. (Tr. at pp. 59-62) The Panel found that ER's initial testimony was not credible, particularly in light of the fact that he later recanted it. Moreover, May testified that he had a practice of printing and circulating PentaStar press releases to all customers who purchased PentaStar. (Tr. at pp. 162-163, 240-241) The Panel found May's testimony to be credible, particularly in light of the corroborating testimony of Thomas O'Rourke, the President of Schneider (as to the practice of mailing press releases) and RS (as to the fact that he regularly received Pentastar press releases). (Tr. at pp. 235-239)

2. Customer ST's Account (allegations of material omissions and unsuitable recommendations)

Customer ST owned four car dealerships. As indicated on his account opening form, he had a net worth of $8 million, annual income of $2 million, and liquid net worth of $3 million. (CX-18; Tr. at p. 81) His account opening form also reflected ST's investment objective as a percent of available assets as 25% - "aggressive growth" and 25% speculative, with a risk tolerance of 25% - "high risk." (CX-18; Tr. at p. 114) ST was an experienced investor, who had 20 years of experience trading Nasdaq listed stocks, trading on margin and purchasing highly speculative stocks outside his account with May. (Tr. at pp. 91-92, 108, 113)

It is undisputed that May recommended PentaStar to ST, although ST acknowledged that some of the purchases could have been ST's idea. (Tr. at pp. 84-85) ST recalled that he had numerous conversations with May about PentaStar, as well as several other stocks. (Tr. at pp. 85-86) It is undisputed that ST had frequent conversations with May as the price of PentaStar was dropping. (Tr. at pp. 84-86, 89, 105-106) In the Fall of 2001, May told ST that the stock price dropped due to contract trouble with a provider, which ST thought was Verizon.[9] (Tr. at pp. 93, 99) May and ST discussed that PentaStar was reducing costs. (Tr. at p. 97) During these conversations, May continued to recommend PentaStar to ST because he believed the stock was inexpensive. (Tr. at pp. 93-94) ST received press releases regarding PentaStar from

[9] While ST later testified that he did not recall hearing that Verizon was not going to renew its contract with PentaStar, the Panel discounted this testimony, given ST's earlier specific recollection that the conversation occurred, and given ST's later testimony that he discussed the loss of Verizon in February 2002. (Tr. at pp. 95, 99) The Panel found that the first conversation relating to Verizon occurred in the Fall of 2001, consistent with ST's earlier testimony.

May, and he may also have received PentaStar's SEC filings from May. (Tr. at pp. 94, 105; footnote 9, *supra*) From his initial investment in PentaStar, ST periodically followed the price on-line. (Tr. at pp. 98, 104)

ST invested approximately $108,000 in PentaStar during the period alleged in the Complaint - August 2001 through February 2002. ST lost approximately $104,000 of this investment in March 2002 when PentaStar went out of business. (RX-77; Stipulation 9; CX-16; Stipulation 10)

3. Customer RS's Account (allegations of unsuitable recommendations)

Customer RS was a medical doctor. As indicated on his account opening form, he had a net worth of $3 million, an annual income of $120,000, and a liquid net worth of $3 million. (CX-30; Tr. at pp. 206-207) As indicated on his account opening form at Schneider, RS's investment objective as a percent of available assets was 30% - "aggressive growth," with a risk tolerance of 80% - "high risk." (CX-30; Tr. at p. 114) RS had five years experience investing in penny stocks. (Tr. at p. 232) RS maintained a margin account at Schneider, and purchased PentaStar on margin. (CX-31; Tr. at pp. 91-92)

RS was an experienced investor who also maintained an account at another brokerage firm, which was about equal in size to the account at Schneider. (Tr. at pp. 208) Additionally, consistent with his stated investment objectives, RS previously had invested in speculative securities with May. (Tr. at p. 270) In particular, RS invested $30,000 in a private placement through May, which he sold on May's recommendation, making $800,000. (Tr. at pp. 271-272) RS had also invested in Laser Vision using a margin account. (Tr. at p. 275)

RS purchased PentaStar on May's recommendation. RS recalled receiving press releases regarding PentaStar from May over time. He testified, "I probably looked at them very briefly and went back to my trust level and didn't pay that much attention to them." (Tr. at p. 236) In December 2001, RS recalls that May told him that PentaStar would be purchased and RS would end up recouping some of the losses. (Tr. at p. 219) RS never raised the possibility of selling PentaStar and May never recommended it. (Tr. at p. 220)

RS invested approximately $594,000 in PentaStar between October 1999 and May 2001, a period that predates the purchases alleged in the Complaint. RS made additional investments of approximately $192,000 in PentaStar stock during the period alleged in the Complaint – June 2001 through August 2001. (RX-77) RS lost approximately $152,000 of this investment when PentaStar went out of business. (RX-77; Stipulation 9; CX-16; Stipulation 10)

4. Customer CJ's Account (allegations of unsuitable recommendations)

Customer CJ did not testify at the Hearing, but a letter from CJ to May was admitted into the record. (CX-36) CJ was a consulting engineer. As indicated on his account opening form, he had a net worth of over $2 million, annual income of over $150,000, and liquid net worth of over $1 million.[10] (CX-34) His account opening form reflected CJ's investment objective as a percent of available assets as 100% - "capital appreciation," with a risk tolerance of 50% - "high risk." (CX-34; Tr. at p. 114) As

[10] The account opening form indicates $1 million net worth and $2 million liquid net worth, but there are arrows suggesting that these numbers should be flipped. Given that net worth should be larger than liquid net worth, and given the arrow on the form, the Panel finds that the form was intended to indicate $2 million in net worth and $1 million in liquid net worth. (CX-34)

indicated on his qualification form for options trading, CJ rated growth and speculation, respectively, as his investment objectives. (RX-33)

CJ was an experienced investor, with over 10 years of experience trading options, over 15 years trading equities, and securities accounts with several other brokerage firms. (RX-33) CJ had accumulated a large position in Laser Vision in the past, a similarly speculative company in that it also was not generating net income at the time. (Tr. at pp. 308-310) In the case of Laser Vision, May recommended that CJ sell for a profit, but CJ did not follow that advice, preferring instead to hold the position in hopes of further appreciation. (Id.; Tr. at pp. 156-159.) May did not recommend that CJ sell PentaStar following adverse public announcements, because May believed that PentaStar's prospects would change and the Company would be sold at some point. (Tr. at p. 309)

CJ invested approximately $150,000 in PentaStar between October 1999 and September 2000, a period that predates the purchases alleged in the Complaint. CJ made additional investments of approximately $210,000 in PentaStar during the period alleged in the Complaint - February 2001 through August 2001. (RX-77) These additional investments occurred prior to PentaStar's August 14, 2001 adverse press announcements.[11] CJ lost approximately $204,000 of his additional investment when PentaStar went out of business. (RX-77; Stipulation 9; CX-16; Stipulation 10)

[11] CJ purchased approximately $1,700 in PentaStar stock on August 14, 2001. The record does not establish whether the purchase occurred before or after the public filing, and so the Panel cannot find that the purchase followed the announcement. (RX-77; Stipulation 9)

5. Customer RI's Account (allegations of material omissions and unsuitable recommendations)

Customer RI owned a produce business. As indicated on his 1993 account opening form, he had a net worth of $1 million and an annual income of $100,000.[12] (CX-23; Tr. at pp. 121, 147) The account opening form also indicated that RI's investment objectives, ranked in order of priority, were *income*, *safety*, growth and speculation. (Italics added) (CX-23) RI had no other securities accounts and limited investment experience. (Tr. at pp. 121-122) Thus, RI's investment objectives were more conservative than those of the other investors in this case, and his resources were more limited.

RI purchased PentaStar on May's recommendation. (Tr. at p. 122) RI testified that he discussed PentaStar with May prior to his first purchase, and RI determined to follow May's recommendation. RI and May communicated from time to time regarding PentaStar, RI received PentaStar press releases from May, and they discussed PentaStar as the price continued to drop.[13] According to RI, at some point he raised the idea of selling PentaStar, but May said the stock would come back so RI did not sell at that time. (Tr. at pp. 127-128) May and RI also discussed that RI knew one of the principals of PentaStar. (Tr. at p. 246)

May believed that RI's financial resources were greater than those disclosed on his account opening form. May believed that RI had a very successful produce business,

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[12] RI testified that the account opening form notation of 100M+ net worth meant that RI had $1 million plus in net worth. (Tr. at p. 147)

[13] While RI initially testified that May did not contact him after the initial purchase of PentaStar, and that May continued to purchase PentaStar in RI's account without discussing either the purchases or any PentaStar announcements (Tr. at pp. 123-131), the Panel did not find this testimony to be credible, particularly given RI's later testimony that some conversations had occurred. Moreover, while RI testified that he did not think he received PentaStar press releases (Tr. at p. 135), the Panel rejected this testimony given the previously noted evidence that press releases were mailed. See footnote 8.

and although he did not know the revenues of the business, he believed the business to be very profitable. He also believed that the business had no debt. He noted that RI also belonged to nice country clubs in Colorado and Arizona, had a nice house and drove nice cars. May estimated that RI had a net worth of $3 million and annual income of $200,000. (Tr. at pp. 244-249)

RI invested approximately $113,000 in PentaStar stock from the period alleged in the Complaint - August 14, 2001 through February 2002. RI lost approximately $111,000 of this investment when PentaStar went out of business in March 2002. (RX-77; Stipulation 9; CX-16; Stipulation 10)

6. Customer SF's account (allegations of unauthorized trading)[14]

Customer SF was an ophthalmologist. SF opened an account with May at Schneider in 2000. SF purchased Laser Vision securities at May's recommendation. SF also purchased a small number of PentaStar shares at May's recommendation. However, in October and November 2000, May purchased four 700-share blocks of PentaStar in SF's account without authority. (CX-38, CX-39, CX-40; Tr. at pp. 23-26) May acknowledged to SF that he had made a mistake, but he convinced SF to hold on to the shares. (Tr. at pp. 282-283)

May's explanations for these unauthorized trades changed over time, and none of his explanations were credible. First, May sent a fax to SF stating that "one purchase of 700 shares of PentaStar was duplicated 3 additional times," and acknowledging that the transactions were in error. (CX-41) May later explained that he gave a ticket to his operations person to fix the errors. (Tr. at p. 325) However, the order tickets for the

[14] In the Complaint, SF was incorrectly referred to as WF. (Transcript of August 25, 2004 Pre-hearing Conference, pp. 9-10).

transactions were on different dates, ranging from October 26, 2000 through November 21, 2000, they were all in May's handwriting, and they were all "Buy" tickets. (CX-40) May testified at the hearing that he had no memory of writing the tickets, and no explanation for the errors. (Tr. at pp. 285-286, 325-330)

III. Charges

A. Count 1: Material Omissions of Fact

The Complaint alleges that during the period from approximately August 15, 2001, through December 2, 2001, May omitted to disclose material information regarding PentaStar in connection with his recommendations that his customers ER, ST, and RI purchase PentaStar – recommendations that these customers followed. In particular, the Complaint alleges that May failed to disclose information relating to PentaStar's financial results for the second quarter of 2001, PentaStar's violation of certain financial covenants with its primary bank lender resulting in a default under the terms of the loan agreement, and its announcement that it lost its major customer, Verizon. The Complaint charges that the omissions violated Section 10b-5 of the Exchange Act, SEC Exchange Rule 10b-5, and NASD Rules 2120 and 2110.

In order to establish a violation of Section 10(b) of the Exchange Act and Rule 10b-5, Enforcement must show that May made material misrepresentations or omissions in connection with the purchase or sale of a security, and that he acted with scienter SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996). NASD Conduct Rule 2120, NASD's anti-fraud provision, parallels Rule 10b-5. Dep't of Enforcement v. Justin E. Apgar, 2004 NASD Discip. LEXIS 9 at *11 (NAC May 18, 2004). Both are designed to "ensure that sales representatives fulfill their obligation to their customers to be accurate when making statements about securities." DBCC v. Euripides, 1997 NASD Discip.

LEXIS 45 at *16-17 (July 28, 1997). A violation of NASD Conduct Rule 2120 is also a violation of Conduct Rule 2110. Id. at 19.

Contrary to the allegations in the complaint, the Panel found that May sent PentaStar's announcements to his customers, and had regular communications with them, including discussions regarding adverse developments. (See footnote 8) These findings were based not only on the testimony of May, but also the testimony of his customers.

For example, ST generally admitted that he had frequent discussions with May, on various subjects, including: PentaStar's trouble with a contract provider, possibly Verizon; PentaStar's cost reduction efforts; and May's belief that PentaStar was inexpensive. ST also stated that May sent him PentaStar press releases, and possibly SEC filings. Similarly, RI acknowledged that he and May communicated from time to time regarding PentaStar as the price continued to drop, and May sent RI PentaStar press releases.

To the extent that ER originally complained that he did not receive information about PentaStar from May, his account changed upon cross-examination at the Hearing. For example, while ER originally testified that he never spoke with May about PentaStar purchases, and May "just did them," he later recanted this testimony when confronted with account statements showing he had made contemporaneous deposits to his account for the exact amount of the PentaStar purchases. (See footnote 7) Similarly, while ER also testified that he did not receive press releases, he later admitted that he recalled receiving one, and he may have received more. He also admitted that he might have discussed PentaStar's adverse public announcements with May. Mailing of the press releases was also corroborated by Thomas O'Rourke, who testified that it was May's standard practice to do so. (Tr. at pp. 237-239)

Based on the foregoing, the Panel found that the Complainant failed to show by a preponderance of the evidence that May omitted to disclose material adverse information about PentaStar.

B. Unsuitable Trading

The Complaint alleged that May's recommendations to invest in PentaStar were unsuitable during two time periods. The charges relating to CJ and RS concern accumulations over the periods from February through June 2001, and June through August 2001, respectively, time periods that predated PentaStar's adverse public announcements. Enforcement's theory with respect to the CJ and RS accounts is that they were unduly concentrated in PentaStar stock, such that they were subject to a disproportionate risk. The charges relating to ST, ER, and RI concern purchases that occurred after the August 14, 2001 10-Q release of second quarter results. Here, in addition to the customer specific circumstances, Enforcement's theory is that, after August 14, 2001, a PentaStar investment was unsuitable for anyone. (Complainant's Brief at pp. 11-12)

Rule 2310 provides that in recommending to a customer the purchase of a security, a member or associated person must have reasonable grounds for believing that the recommendation is suitable for the customer based on the facts, if any, disclosed by the customer as to her other security holdings and as to her financial situation and needs.

"A broker's recommendations must be consistent with his customer's best interests. The test for whether [the broker's] recommended investments were suitable is not whether [the customer] acquiesced in them, but whether [the broker's] recommendations … were consistent with [the customer's] financial situation and needs."

Wendell D. Belden, Exch. Act Rel. No. 47859, 2003 SEC LEXIS 1154 (May 14, 2003) (footnotes omitted).

With respect to the allegation of unsuitability due to over concentration in RS's account, the Panel considered RS's financial circumstances, including a liquid net worth of over $3 million, and his investment objectives of 30% "aggressive growth" with a risk tolerance of 80% high risk. The Panel also considered the magnitude of RS's investment – ranging from approximately $618,000 to $787,000 during the time frame at issue (with a market value, at the time, ranging from $1,039,000 to $1,162,000), as well as his investment experience and history of investing, including prior investments in a private placement and other speculative stock. Similarly, as to the alleged over concentration in CJ's account, the Panel considered CJ's liquid net worth of over $1 million, his investment objectives of capital appreciation, growth and speculation, and his risk tolerance of 50% "high risk," along with the magnitude of his investment –ranging from approximately $153,000 to $356,000 during the period at issue (with a market value, at the time, ranging from $269,000 to $413,000), as well as his investment experience and history of similar investments. The Panel did not find that purchases of PentaStar in the CJ and RS accounts were unsuitable in either case. In both cases, the strategy of accumulating a position in a speculative security was consistent with the customers' investment objectives, and within their financial means. While an investment in a single speculative security does increase the risk of the investment, in these cases, this was a risk that the investor chose to and could bear. Moreover, in both cases, these investors had engaged in such a strategy in the past, and they were aware of the potential risks and rewards of doing so.

With respect to the allegations relating to PentaStar investments by ER, ST and RI, Enforcement argues that after PentaStar's August 14, 2001 public announcement of second quarter losses and a default under the terms of its loan, an investment in PentaStar was unsuitable for anyone. As a threshold matter, on the facts of this case, the Panel rejected the notion that PentaStar was per se unsuitable after its public announcement. Enforcement has cited no prior decision holding that a broker may not recommend a speculative security following adverse news, and the Panel declines to establish such a standard. On the contrary, assuming full disclosure of material information and that the nature and magnitude of the investment are otherwise suitable for the customer, an investment in a stock after adverse news may be fully consistent with a strategy employed successfully by some investors who look to invest in out-of-favor stocks.

Turning to the issue of whether the specific investments in PentaStar that May recommended were suitable for ER, ST and RI, the Panel considered each investor's investment objectives, needs and financial circumstances. ER had a net worth of over $1 million, a liquid net worth of $1.1 million, with an investment objective of aggressive growth for 50% of his assets, and a high risk tolerance for 50% of his assets. ST had a net worth of $8 million, a liquid net worth of $3 million, his investment objective was speculative for 25% of his assets and aggressive growth for 25% of his assets, and his risk tolerance for 25% of his assets was high. ER and ST were sophisticated investors with aggressive growth strategies, high risk tolerance, other brokerage accounts and prior margin trading experience. The Panel did not find that May's recommendations to purchase PentaStar were unsuitable for these investors.

On the other hand, RI had a net worth of $1 million and annual income of $100,000. His liquid net worth was not disclosed on his account opening form, and,

while May believed that RI had more in the way of financial resources than his account form disclosed, this was based on May's observations, rather than any concrete information or discussions with RI. RI's investment objectives, in order of priority, were "income, safety, growth and speculation."

RI's situation was distinguishable from May's other customers in this case – his investment objectives were more conservative, and his resources were more limited. RI also had limited investment experience and no other securities accounts. An investment in PentaStar was clearly not consistent with RI's investment priorities of income and safety. The Panel found that May's recommendation that RI purchase PentaStar was unsuitable.

For these reasons, the Panel found that May's recommendation was unsuitable for one customer, RI, but did not find that Enforcement met its burden with respect to the remaining customers.

C. Unauthorized Trading

The Complaint alleges that May effected four unauthorized transactions in SF's account. It is well settled that unauthorized trading in a customer's account violates the requirement under Rule 2110 that members observe just and equitable principles of trade. See Robert Lester Gardner, 52 S.E.C. 343, 344 (1995), aff'd, 89 F.3d 845 (9th Cir. 1996) (table format).

At the Hearing, while May said he had no memory of writing the order tickets, he also admitted that the tickets, which had dates ranging from October 26, 2000 to November 21, 2000, were in his handwriting. May does not dispute the fact that the

trades occurred and were unauthorized, and in fact he sent a fax to SF admitting that the trades were done in error.

For these reasons, the Panel found that May engaged in unauthorized trading.

IV. Sanctions

A. Suitability

The recommended sanctions for unsuitable recommendations are a fine of $2,500 to $75,000 and a suspension of 10 days to one year, or, in egregious cases, a bar. NASD Sanction Guidelines (2005 ed.) ("Guidelines") at p. 99. General Principle No. 5 of the Guidelines also provides that where appropriate to remediate misconduct, a respondent should be ordered to make restitution to the injured customer. Enforcement requested that May be suspended one year, pay a fine of $25,000, and pay restitution for the suitability charges. (Tr. at pp. 374-376)

The Panel applied the factors or "Principal Considerations" suggested in the Guidelines and found that a fine of $5,000, a suspension of three months in all capacities, and $91,158 in restitution to RI for losses resulting from May's unsuitable recommendations were appropriate.[15]

In making this determination, the Panel considered the following Principal Considerations. May did not accept responsibility for the unsuitable recommendation, and he did not pay full restitution. However, May did not attempt to conceal his conduct, and he was not motivated by monetary gain, earning only approximately $1,000 in commissions for the transactions. (CX-11; Stip. 22)

[15] The parties stipulated that RI suffered losses of $111,158 in connection with the unsuitable recommendation charges. (CX-16; Stip. 10) RI testified that he recovered $20,000 in connection with a settlement of an arbitration claim. The Panel offset the amount of loss by the settlement recovered by RI.

B. Unauthorized Trading

The recommended range for unauthorized transactions is a fine of $5,000 to $75,000 and a suspension of 10 business days to one year, or, in egregious cases, a bar. Guidelines at p. 103.[16] Enforcement requested that May be suspended six months and fined $10,000 for the unauthorized transaction charge.[17] (Tr. at pp. 374-376).

The Panel applied the factors or "Principal Considerations" suggested in the Guidelines and found that a fine of $25,000 and a suspension of one year were appropriate. In this regard, the Panel noted that there were four separate incidences of unauthorized trading, and May attempted to conceal his conduct by initially mischaracterizing it as a duplication of an error, and later offering differing explanations of how the trades occurred, none of which was credible. On the other hand, by the time of the hearing May accepted responsibility, did not appear to be motivated by monetary gain, and he did not dispute that the trades were not authorized.

V. Conclusion

For making unsuitable recommendations, Respondent is fined $5,000, ordered to make restitution to RI in the amount of $91,158, and is suspended in all capacities for three months. For engaging in unauthorized transactions, Respondent is fined $25,000, and is suspended in all capacities for one year. The suspensions shall run concurrently. In addition, Respondent is ordered to pay costs in the amount of $2,821.82, which

[16] Under the Guidelines, there are three categories of egregious cases: (1) quantitatively egregious unauthorized trading; (2) unauthorized trading accompanied by certain aggravating factors; and (3) qualitatively egregious unauthorized trading, as determined by the strength of evidence that the trades were unauthorized and the Respondent's motives in effecting the trade. The Panel found that none of these categories were present in this case.

[17] Enforcement did not request restitution for the unauthorized trading charge, nor is there record evidence sufficient to determine whether restitution is appropriate.

includes an administrative fee of $750 and Hearing transcript costs of $2.071.82.[18] Enforcement failed to prove by a preponderance of the evidence that Respondent omitted to disclose material information in violation of Section 10(b) of the Securities Exchange Act of 1934, Securities Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110, and accordingly, that charge is dismissed.

The foregoing sanctions shall become effective on a date set by the NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of the NASD, except that if this decision becomes NASD's final disciplinary action, May's suspension shall begin at the opening of business on July 5, 2005 and end at the close of business on July 4, 2006.

HEARING PANEL

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By: Sara Nelson Bloom
Hearing Officer

Copies to:

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Jacqueline D. Whelan, Esq. (via electronic and first class mail)
Rory C. Flynn, Esq. (via electronic and first class mail)

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