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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. 2005000315901 Hearing Officer – AWH **HEARING PANEL DECISION** December 15, 2006

Registered representative and principal who supervised 70 to 90 registered representatives failed reasonably to supervise three of 20 recommendations for mutual fund transactions in the account of one customer of one of those registered representatives. Respondent fined $5,000, and assessed costs.

Appearances:

Lynn M. Kaseta, Esq., and Michael Newman, Esq., for the Department of Enforcement

Peter J. Anderson, Esq., and Olga Greenberg, Esq., for Respondent

DECISION

Introduction

On March 1, 2006, the Department of Enforcement filed a Complaint against Respondent, alleging that he failed to supervise BC, a registered representative who engaged in unsuitable mutual fund switch transactions in a customer's account. On March 29, 2006, Respondent filed an Answer, Affirmative Defenses, and Request for Hearing. In that pleading, Respondent asserts that he relied on BC's fraudulent misrepresentations in approving the transactions at issue, and he supervised BC reasonably, given the resources provided to him by his broker-dealer. He also asserts that BC agreed to pay restitution to the customer and was fined and suspended by NASD.

A hearing was held on August 1, 2006, in Woodbridge, New Jersey, before a hearing panel composed of the Hearing Officer and two former members of the District 9 Committee. The parties filed post-hearing submissions on October 13, 2006.[1]

Findings of Fact[2]

I. Respondent, Registered Representative BC, and the Customer

After graduating with a degree in Economics from Yale University, Respondent entered the securities business in 1993 and became a registered representative with ["Firm 1"]. In June 1997, he became registered as a General Securities Principal. From June 1997 through at least June 2004, he was the Securities Coordinator for Firm 1's _____, _____, branch office. The branch office was also an agency known as ["Firm 2"]. In about June 2004, Firm 1 ceased to conduct a securities business. At that time, Firm 2 joined ["Firm 3"], and Respondent became, and is currently, registered through Firm 3.[3]

As the Securities Coordinator for Firm 1, Respondent was responsible for supervising, monitoring, and approving the securities transactions of BC, as well as 70 to 90 other registered representatives. Respondent was also responsible for instituting the compliance culture at Firm 2. He regularly drafted memoranda and notices to registered representatives apprizing them of regulatory and compliance topics, including

[1] On October 16, 2006, Respondent filed a motion to strike the Department of Enforcement's post-hearing brief on the grounds that it exceeds the 25 page limitation of Rule 9266(d) and unfairly prejudices Respondent. On October 17, 2006, the Department of Enforcement filed its opposition to the motion, asserting that if it had single-spaced certain text as allowed by Rule 9136, its post-hearing brief would comply with Rule 9266, and that, in any event, there is no prejudice to Respondent. Enforcement also notes that Respondent's brief, if double-spaced as required by Rule 9136, would exceed the 25-page limitation. However, Enforcement does not move to strike Respondent's post-hearing brief. Respondent's motion is denied. Enforcement's post-hearing brief complies with the spirit of the Procedural Rules, and Respondent is not prejudiced by the format of the filing.

[2] References to the Department of Enforcement's exhibits are designated CX-; Respondent's exhibits, as RX-; joint exhibits, as JX-; and the transcript of the hearing, as Tr.-.

[3] Tr. 108-09; JX-2 ¶¶ 1-2.

replacements and switching of mutual fund investments, and regularly met with registered representatives to review a sample of client files.[4]

In June 2000, customer GL opened an account at Firm 1, with BC as the registered representative on the account. At the time she opened the account, GL was approximately 55 years old, and had an annual income of approximately $30,000. She opened the account with a deposit of $55,000, and, one week later, she transferred two mutual funds, worth approximately $96,500, into her account.[5]

From July 2000 through November 2002, Respondent reviewed and approved a number of transactions in GL's account that had been recommended by BC. BC's mutual fund switch recommendations in GL's account were unsuitable in that GL unnecessarily paid up-front sales charges totaling $5,161.75 for the purchase of Class A shares and paid contingent deferred sales charges ("CDSC") totaling $5,602.69 for the premature liquidation of Class B mutual fund shares. In August 2003, a few months after BC left Firm 1, GL called Respondent to meet and discuss the activity in her account. Upon review of her account statements and other paperwork she brought to the meeting, Respondent concluded that there were several mutual fund replacements that were not in GL's best interests. He encouraged GL to file a complaint with NASD, and he promptly reported BC's activities to Firm 1's compliance department. As a result of an investigation into his misconduct, BC agreed to an NASD Letter of Acceptance, Waiver, and Consent under which he received a four-month suspension, a fine of $10,000, and an order to pay $19,786.97, plus interest, in restitution to GL.[6]

[4] *See, e.g.*, Tr. 125-26; RX-1, RX-2, RX-4, RX-8, p. 2, RX-9, p. 5, RX-18, p. 2.
[5] Tr. 21-23; JX-1, JX-2 ¶ 4.
[6] Tr. 141-43, 206-07; JX-2, ¶¶ 5-8.

II. Firm 1's Policies and Procedures for Suitability Reviews

A. The Application and the Cover Sheet

The Firm 1 supervisory procedures required that, for initial transactions, securities coordinators review "each application and accompanying suitability information" submitted to Firm 1 by registered representatives. For existing clients, the securities coordinators were required to review "subsequent transactions and their accompanying Cover Sheet for Existing Clients." As pertinent to this case, the procedures required securities coordinators to consider (1) "[w]hether the investment is suitable for the purchaser in light of the purchaser's financial needs, risk tolerance, investment objectives, age and economic circumstances," (2) "[W]hether the sale involves any churning or 'switching,'" and (3) whether the "replacement section" is "completed, signed by the client" and the "rationale for the replacement reasonable."[7]

Initially, when submitting a mutual fund trade in an established client's brokerage account, a registered representative was not required to complete any paperwork other than the trade ticket. Respondent instituted the requirement that a registered representative submit a Cover Sheet for those transactions so that he could conduct a suitability review of mutual fund transactions.[8]

The Cover Sheet is a document contained on the front and back of a single sheet of paper. The front of the Cover Sheet provides basic suitability information, such as the name of the security, the date of sale or purchase, the amount of the transaction, and the customer's investment objectives, time horizon, and source of funds. There is also a "yes" and a "no" box to indicate whether the transaction is a replacement. The document also states on the front that, if the transaction is a replacement, the Replacement

[7] CX-2, pp. 2-3; CX-4, p. 2.
[8] Tr. 131-32.

Information section on the back of the Cover Sheet is to be completed. "Section A" is the Replacement Information form on the back of the Cover Sheet. Section A is completed to show the existing investment, the new investment, any surrender charges, and the reasons for the replacement. If the replacement exceeds $5,000, the customer is required to sign Section A to acknowledge her approval of the transaction.[9]

B. On-line Account Access

In 2000, a securities coordinator could view on-line only the latest 30 days of a customer's account history. In 2002, a securities coordinator had on-line access to the latest 90 days of that history. However, there was no Firm 1 policy or procedure that required a securities coordinator to review a customer's account history in approving a mutual fund transaction. During the time period at issue, there were no automated exception reports available to a securities coordinator to assist him in his suitability review of mutual fund transactions.[10]

C. Commission Reports

Commission reports were distributed to each representative as an attachment to a bi-weekly paycheck. The reports summarized commission rates and amounts, and contained the clients' names, as well as the dates and amounts of transactions. They provided a general overview of a representative's activity, and Respondent reviewed commission reports to determine if any commissions were irregular. However, Firm 1 policies and procedures did not require him to use those reports when conducting suitability reviews of mutual fund transactions.[11]

[9] Tr. 27-29; CX-10.
[10] Tr. 86, 133, 140, 182,
[11] Tr. 31, 86, 134-35.

III. The Mutual Fund Transactions

To more easily view the flow of funds in GL's account, the mutual fund transactions will be grouped into five sets. The Department of Enforcement does not assert that Respondent failed to supervise the initial deposit of cash, the purchase on July 26, 2000, of four mutual funds with the initial deposit, and the transfer-in of two mutual funds.[12] However, information pertaining to those transactions will be detailed below to aid in following the flow of funds.[13] The Department of Enforcement does assert that Respondent failed to supervise the remaining 28 transactions that BC noted on 20 cover sheet recommendations dated from August 8, 2000, through November 4, 2002. The Hearing Panel's analysis of the transactions follows the description of each transaction set. The analysis is from the perspective the Hearing Panel believes Respondent had at the time he approved the paperwork, not from a hindsight overview of the entire universe of transactions in GL's account that are at issue in this proceeding.[14]

A. Transactions from June 2000 through December 2000.

1. Initial deposit and purchases.

On July 24, 2000, GL deposited $55,000 which, two days later, funded the purchase of three IDEX Class B funds (in amounts respectively of $15,000, $10,000, and $10,000) and $20,000 of American Growth Fund Class B.

2. Initial transfers-in, sales of transferred shares, and purchases.

On August 1, 2000, GL transferred-in shares of Van Kampen Prime Rate Class B in the amount of $40,462.86, and Van Kampen Enterprise Class B in the amount of

[12] Department of Enforcement's Post-Hearing Brief, n. 18.
[13] The information is taken from Joint Exhibit 1. Other exhibits will be noted in subsequent footnotes. For convenience, the mutual funds will be identified by abbreviated names.
[14] As noted previously, there is no dispute that, looking at the universe of transactions in GL's account in light of all the information relevant to those transactions, BC's mutual fund sales and purchase recommendations were unsuitable. Respondent, himself, was the first to recognize that fact after he was able to view the paperwork that GL brought to the meeting she had with him after BC left the firm.

$55,951.68. On a Cover Sheet dated August 8, 2000, Respondent approved a sale of $10,000 of Van Kampen Enterprise. The front of the Cover Sheet indicated that the transaction was not a replacement, and, on the back, Section A had no replacement information entered.[15]

On a Cover Sheet dated August 11, 2000, Respondent approved a purchase in the amount of $10,000 of Oppenheimer Capital Appreciation Class B. The front of the Cover Sheet indicated that the funds came from a money market fund and the purchase was not a replacement. The back of the Cover Sheet was blank. The commission report for the pay period ending August 22, 2000, listed together the sale of Van Kampen Enterprise, which Respondent had approved on August 8, and the purchase of Oppenheimer Capital Appreciation, which Respondent had approved on August 11. There was no commission on the sale; the report showed a commission of $400 on the purchase. As noted above, commission reports came out every two weeks, and Respondent reviewed them for "irregular" amounts.[16]

On October 13, 2000, BC sold $30,000 of GL's Van Kampen Enterprise shares and, on October 18, 2000, $39,594.16 of her Van Kampen Prime Rate shares.[17] The Cover Sheet for those sales indicated that they were not replacements. On the Cover

[15] The NASD Special Investigator testified that Respondent would have no reason to believe this transaction involved a replacement. Tr. 72-73. Nevertheless, on brief, Enforcement asserts that, "because Class B shares of mutual funds are long-term investments," the front of the Cover Sheet incorrectly identifies GL's time horizon of the investment as "Less than 5 years," and that, therefore, Respondent should have given the transaction further scrutiny. However, there is no evidence that Respondent had reason to question why GL may have wanted to liquidate a portion of her holdings in this investment for cash. Enforcement also points out that the box indicating Investment Objectives was incorrectly marked "Income," and not "Capital Appreciation." However, in supervising subsequent transactions for existing clients, Respondent was expected to rely on the Cover Sheet representation of the registered representative, and was not required by Firm 1's policy and procedures to go back to the client's New Account form or the client file to verify the investment objective or other suitability information on the Cover Sheet. Tr. 86, 132.

[16] Tr. 31, 134. There is no allegation or evidence that the $400 commission was unusual or irregular.

[17] The shares were part of the holdings that were transferred in on August 1, 2000.

Sheet for the Enterprise sale, there is an instruction to deposit the proceeds in a money market fund.

On October 19 and 24, there were four purchases of mutual funds: one for $30,000 of American Investment Class B (the identical amount to the sale of Van Kampen Enterprise), and three in the total amount of $39,500 (approximately the amount of the sale of Van Kampen Prime Rate). The Cover Sheets for the purchases indicated that the source of funds was a money market fund and that the transactions were not replacements. However, the backs of the Cover Sheets were identical and contained required replacement information. That information noted the combined sale of the Enterprise and Prime Rate funds, with the explanation that GL wanted to reposition and diversify her funds into American Investment ($30,000), Eaton Vance Worldwide Health ($10,000), Eaton Vance Income ($20,000) and Oppenheimer Capital Appreciation ($9,500). The Cover Sheets did not indicate that B shares were being sold, and stated that no surrender charges were incurred. GL signed the back of the Cover Sheet, indicating that she understood and agreed with the reasons for the replacement.[18]

On December 8, 2000, Respondent approved the purchase of Sun America Focused Growth B in the amount of $6,000.00 and Pimco Target B in the amount of $5,300.00. The front of the Cover Sheet indicated that the purchases were not replacements. On the reverse side, Section A stated that money market funds would be the source of funds, and no surrender charges were involved. GL signed Section A, indicating that she agreed with the explanation that the purchases were part of her asset allocation strategy to diversify holdings.

[18] CX-10, pp. 19-22.

On December 12, 2000, Respondent approved the sale of the remaining Van Kampen Enterprise shares, in the amount of $11,033.40. The Cover Sheet indicated that the sale was not a replacement and did not state that B shares were involved. On the reverse side of the Cover Sheet, Section A was blank, including the line indicating whether any contingent deferred sales charge was incurred.[19]

3. Analysis of the June 2000 through December 2000 Transactions.

The Hearing Panel concludes that no red flag was raised by the August 14, 2000,[20] sale of Van Kampen Enterprise Class B shares in the amount of $10,000. The time horizon and the investment objectives on the front of the Cover Sheet were incorrect. However, as noted previously, because the sale was not an initial transaction, Respondent properly relied on the Cover Sheet representation of the registered representative, and was not required by WS Giffith's policy and procedures to go back to GL's New Account form or the client file to verify the investment objective or other suitability information on the Cover Sheet. The sale of a mutual fund is normally client driven, and there is no commission generated for the registered representative.

The Hearing Panel concludes that no red flag was raised by the August 17, 2000, purchase of Oppenheimer Capital Appreciation Fund B in the amount of $10,000. BC indicated on the front of the Cover Sheet that funds came from a money market account and no replacement was involved. BC obviously knew that the information was false, but Respondent could not have known that it was false at the time he approved the purchase. When Respondent approved the transaction, he had no reason to doubt BC's representations on the Cover Sheet. The Commission Reports showed the sale of Van Kampen and the purchase of Oppenheimer Capital Appreciation on the same page, as

[19] CX-10, pp. 24-27.
[20] Actual transaction dates differ from the dates on the cover sheets pertaining to those transactions.

alleged by Enforcement, but the Commission Reports were issued only every two weeks and would not have been available to Respondent at the time he approved the transactions. Moreover, Firm 1's policy and procedures did not require Respondent to review Commission reports prior to approving mutual fund transactions.

The Hearing Panel concludes that no red flag was raised by the October 13, 2000, sale of Van Kampen Enterprise Fund in the amount of $30,000, or the October 18, 2000, sale of Van Kampen Prime Rate Income Trust in the amount of $39,594.16. At the time he approved these sales, Respondent relied on the representations that no replacements were involved, and that, with respect to the sale of Van Kampen Enterprise, the funds were to be deposited into a money market fund. BC earned no commission on the sales. Firm 1's policy and procedures did not require Respondent to search computer records for the initial transactions in the Van Kampen Funds. Even if he were so required, he would not have had access to those records because the initial transactions were more than 30 days earlier than the sales, and the computer system did not provide more than a 30 day window to view transactions in a customer's account.

The Hearing Panel concludes that no red flags were raised by the four mutual fund purchases on October 19 and 24, 2000. The Cover Sheets stated on the front that no replacements were involved and that the source of funds was a money market account. However, on the back of the Cover Sheet, Section A contained an explanation for the replacements, and a statement that no surrender charges would be incurred. As Enforcement noted on brief, "It is simply illogical that [BC] would have completed a 'replacement form' if the transaction did not involve a *replacement*." (emphasis in the original).[21] Respondent agreed with that assertion. He assumed that BC had merely

[21] Post-Hearing brief, at 13-14.

checked the wrong box on the front of the Cover Sheet.[22] Because Section A did not identify the existing investments as B shares, there is no inconsistency with the absence of any surrender charges to be incurred. GL signed that Cover Sheet, indicating that she understood and approved the transactions.

Finally, the Hearing Panel concludes that no red flags were raised by the December 18, 2000, sale of Van Kampen Enterprise B shares in the amount of $11,033.40, or the purchases on December 26, 2000, of Pimco Target B shares in the amount of $5,300.00, and SunAmerica Focused Growth B shares in the amount of $6,000.00. The sale of GL's remaining shares of Van Kampen Enterprise took place two months after the previous transactions in her account. As a result, Respondent could not have viewed the previous transactions electronically. The source of funds section on the front of the Cover Sheet is not applicable to a sale, and the indication that no replacement was involved was consistent with the fact that a check was attached to the Cover Sheet. The Cover Sheet for the purchases was dated four days prior to the sale of Van Kampen Enterprise and indicated, on the front, that no replacement was involved. On the back of the Cover Sheet, Section A was filled out, indicating that funds from a money market account were to be used for the purchases. BC also provided a written explanation for a replacement, which GL signed. Although the front and back are inconsistent because the back contained an explanation for a replacement while the front indicated that no replacement was involved, there was no reason for Respondent to believe that the funds came from a previous liquidation of a mutual fund, contrary to BC's written representation that the funds came from a money market fund. GL signed the form, assenting to the transactions.

[22] *See, e.g.*, Tr. 195.

B. Transactions in May and June 2001.

1. Sales.

On May 24, 2001, GL sold shares of Oppenheimer Capital Appreciation B ($5,000.00), Pimco Target B ($4,804.71), and IDEX Janus Global B ($5,000.00). The Cover Sheet, dated May 21, 2001, did not list the source of funds, and did not indicate whether a replacement was involved. Section A was blank.

2. Purchases.

On June 1, 2001, GL bought shares of SunAmerica Focused Value B ($10,000.00) and SunAmerica GNMA A ($4,500.00). The Cover Sheet, dated May 24, 2001, indicated that the funds came from money market funds and no surrender charges were incurred. GL signed Section A which indicated that she wished to rebalance her portfolio.[23]

3. Analysis.

These sales and purchases occurred more than five months after the previous transactions in GL's account. The Cover Sheet indicated straight sales, without any replacement involved. Accordingly, the reverse side was blank and did not show any contingent deferred sales charges. Respondent would have no reason to question the Cover Sheet on its own. The purchases were executed six business days after the sales, and the Cover Sheet clearly indicated that the funds to make the purchases came from a money market account. Because there were no contingent deferred sales charges indicated, and GL signed the form below the explanation for the purchases, Respondent had no reason not to approve the transactions. There would be no question of a free exchange within any family of funds because free exchanges are required to be executed

[23] CX-10, pp. 28-31.

simultaneously. The Hearing Panel concludes that no red flags were raised by these purchases and sales.

C. Transactions in August 2001.

1. Sales.

On August 10, 2001, GL sold a portion of two IDEX mutual funds, half of her American Growth Fund, most of her American Investment Fund, and half of her Eaton Vance Income Fund, for a total of $50,000. The Cover Sheet, dated August 6, 2001, indicated that the sales were not replacements, and Section A was left blank, indicating that there were no contingent deferred sales charges.

2. Purchases.

On August 16, 2001, GL bought SunAmerica Focused MidCap A ($10,000), and Bond Fund of America A ($10,000). The Cover Sheets, dated August 10, 2001, indicated that the purchases were replacements for money market funds. GL signed Section A on August 6, 2001, indicating that she agreed with the written explanation that she wished to reposition money market funds according to her asset allocation objectives.[24]

3. Analysis.

These transactions occurred more than two months after the previous transactions in GL's account. Accordingly, Respondent could not have reviewed those previous transactions by computer. The sales alone would not have raised suitability concerns with Respondent because the Cover Sheet indicated that no replacements were involved, nor were any contingent deferred sales charges incurred. However, the sales took place on a Monday, and the Cover Sheet for the purchases was dated only four days later, on Friday. The purchases were for relatively small amounts of "A" shares, which would

[24] CX-10, pp. 32-37.

have incurred up-front sales charges. All but one of the sales earlier that week were of "B" shares, which typically incur contingent deferred sales charges, although the Cover Sheet did not indicate that there were any for these transactions. GL signed the Cover Sheets for the purchases, indicating her agreement with the rationale for the purchases; however, the Hearing Panel concludes that the close proximity of the sales of "B" shares to the purchase of "A" shares should have prompted Respondent to question the purchases and sales to determine whether a switch was, in fact, involved.

D. Transactions in September 2001 through April 2002.

1. September Sales.

On September 28, 2001, GL sold shares of 13 mutual funds in the total amount of $53,439.84. The single Cover Sheet for the sales was dated September 20, 2001. It listed the 13 mutual funds and the amounts of each to be sold. The Cover Sheet indicated that no replacement was involved, and Section A listed no contingent deferred sales charges.[25]

2. December 2001 and January 2002 Purchases.

On December 27, 2001, GL bought shares of SunAmerica GNMA Fund A in the amount of $4,000. The Cover Sheet was dated December 20, 2001. It indicated that no replacement was involved, and funds were from "cash reserves." On January 29, 2002, GL bought $50,000 of SunAmerica GNMA Fund A. The Cover Sheet was dated January 28, 2002. It indicated that no replacement was involved, funds were from a money market account, and the shares were to be added to existing shares in the SunAmerica GNMA Fund.[26]

[25] CX-10, pp. 38-39.
[26] CX-10, pp. 40-42.

3. March and April 2002 Sales.

On March 19, 2002, GL sold $32,000 of the SunAmerica GNMA Fund A shares. The Cover Sheet was dated March 13, 2002. It indicated that no replacement was involved. On April 22, 2002, GL sold $2,000 of the SunAmerica GNMA Fund A shares. The Cover Sheet was dated April 16, 2002, and indicated that no replacement was involved. In the special instructions section, the Cover Sheet stated, "when settles please send out $34,000."[27]

4. The March 2002 Home Office Audit.

On March 27 and 28, 2002, two compliance officers from Firm 1's home office conducted an audit of Firm 2. A number of client files, including GL's, were examined for completeness and to verify that principal review had occurred. In the resulting audit report, there were no findings of any improper mutual fund switching activity in GL's account.[28]

5. Analysis of the Transactions.

The Hearing Panel concludes that no red flags were raised by sales of mutual funds during the month of September 2001. These sales occurred shortly after the tragic events of 9/11/01. Because of a continuing drop in the market after the terrorist attacks, many investors sold off all, or a portion, of their holdings. The Cover Sheet indicated that no replacements were involved, and Respondent had no reason to believe that the transactions were anything other than a straight sell off.

The Hearing Panel also concludes that no red flags were raised by the purchases in December 2001 and January 2002 of shares of SunAmerica GNMA Fund A. The Cover Sheets stated that the purchases were not replacements. One stated that the funds

[27] CX-10, pp. 43-46.
[28] Tr. 143-45; RX-10.

were from "cash reserves"; the other stated that the shares are to be added to existing holdings in the fund. There was no reason for Respondent to question whether any other mutual fund liquidation was involved. The closest prior liquidations had occurred three months earlier, and Respondent would not have had access to that information at the time he approved these purchases.

Finally, the Hearing Panel concludes that no red flags were raised by the sales of SunAmerica GNMA A shares in March and April 2002. BC spread these transactions three to four months from the purchase of those shares. Both Cover Sheets represent that no replacements were involved, and the second Cover Sheet requests that, when both sales settle, the total amount should be sent to the customer. Respondent would reasonably conclude that the proceeds would not be used for another mutual fund purchase.

E. Transactions in October and November 2002.

1. Sales in October 2002.

On October 25, 2002, GL sold her remaining shares of IDEX Funds, American Growth Fund, American Investment Fund, Oppenheimer Capital Appreciation, and SunAmerica Multi-Cap Fund, for a total of $8,012.96. The Cover Sheet was dated October 21, 2002, and indicated that no replacement was involved.[29]

2. Purchase in November 2002.

On November 6, 2002, GL bought shares of SunAmerica Style Select Growth and Income Fund A in the amount of $8,400. The Cover Sheet was dated November 4, 2002; the replacement information was blank, indicating that none was involved.[30]

[29] CX-10, pp. 47-48. The Cover Sheet and Section A are merged into a new form on a single page.
[30] CX-10, pp. 49-50.

3. The October 2002 Home Office Audit.

In October 2002, a compliance officer from Firm 1's home office conducted an unannounced audit of BC's files, including GL's account. As a result of the audit, on November 29, 2002, the compliance officer wrote to BC, seeking information on GL's transfers into three different annuity contracts. Neither the audit nor the letter indicated any question about mutual fund switching in GL's account.[31]

3. Analysis of the Transactions.

The Hearing Panel concludes that no red flags were raised by the transactions. Six months after the prior transaction in GL's account, BC submitted a Cover Sheet for the sale of all remaining shares in six funds held in the account. At the time he approved the transactions, Respondent had no reason to question the indication on the Cover Sheet that no replacement was involved. The subsequent purchase was two weeks later, and because the Cover Sheet did not refer to a previous mutual fund liquidation, Respondent could reasonably conclude that the funds came from a money market account.

Discussion and Conclusions

Rule 3010(a) requires that NASD members "establish and maintain a system to supervise the activities of each registered representative … that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." "A supervisor is responsible for 'reasonable supervision,' a standard that 'is determined based on the particular circumstances of each case.' … The SEC has held that '[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.'"[32]

[31] Tr. 147-48; RX-13, RX-15.
[32] *Department of Enforcement v. VMR Capital Markets*, No. C02020055, 2004 NASD Discip. LEXIS 18 (NAC Dec. 2, 2004).

Enforcement carries the burden of proving that supervision is not reasonable. That burden requires more than a mere showing that an individual "is less than a model supervisor or that supervision could have been better."[33] In determining whether supervision is reasonable, the individual's actions must be analyzed in light of what he knew at the time of each transaction, and not as a totality or with the acuity of hindsight.[34]

It is undisputed that, viewed in their totality over a 16-month period, BC's recommendations to GL were unsuitable. His pattern of spreading purchases and sales over time demonstrates that he systematically avoided detection by his employer of his misconduct. At the time these transactions were executed, there were no switch surveillance tools such as computerized exceptions reports or on-line access to a client's trading history over a period of several months or years. Until Respondent instituted the use of Cover Sheets, a supervisor could only review order tickets to supervise mutual fund transactions. In the absence of the kind of robust compliance mechanisms that are available today, it is not surprising that Respondent did not detect misconduct by one registered representative among 70 to 90 others, in the account of a single client.

As listed below, paragraph 10 of the Complaint alleges that Respondent ignored six red flags relating to BC's trading in GL's account. However, viewed from Respondent's perspective at the time he reviewed the trades, with one exception, the Hearing Panel does not find that Enforcement proved by a preponderance of the evidence that he failed reasonably to supervise those transactions:

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[33] *Dist. Bus. Conduct Committee v. Dunniway*, 1997 NASD Discip. LEXIS 48, *15 (NBCC 1997).
[34] *Dist. Bus. Conduct Committee v. Lobb*, 2000 NASD Discip. LEXIS 11, *22 n. 19 (NAC Apr. 5, 2000); *see also, James H. Thornton*, Exchange Act Release No. 41,007 (Feb. 1, 1999) (Comm'r Unger, concurring) (Commission's decisions have been careful not to substitute the knowledge gleaned with hindsight, of actual wrongdoing by someone under a supervisor's control, for an assessment of whether the supervisor's conduct was proper under the circumstances.).

1. BC's overall pattern of switching. Respondent could not have been aware of the overall pattern of switching, because he did not have access to that information when he reviewed the recommendations. The timing of the transactions put them outside the window of computerized access to trading history, and the sheer number of representatives and transactions Respondent supervised made it impractical, if not impossible, to review each client's file every time he reviewed a recommended transaction. Moreover, there were no supervisory policies or procedures that required Respondent to research the client's file or trading history when reviewing transactions subsequent to the opening of an account.

2. GL's short holding periods of long-term securities. With the exception of two instances of sales, BC indicated on the Cover Sheets that GL had a time horizon of either "5-10 years," or "Over 10 years." Those time horizons are not inconsistent with the time period over which contingent deferred sales charges decline to zero. The two instances of sales, where the time horizon was listed as "Less than 5 years," are not inconsistent with a client who needs cash for reasons that do not have to be specified to a registered representative.

3. The absence of free exchanges. As noted above, BC systematically avoided detection of his misconduct by separating purchases from sales over varying periods of time. The Hearing Panel notes that free exchanges are not available where the purchase and sale of mutual fund shares occur on different days. Therefore, Respondent would have had no reason to question why a free exchange was not recommended where a sale alone or a purchase alone was the subject of a Cover Sheet recommendation.

4. Substantial front-end or contingent deferred sales charges incurred. BC fraudulently indicated that no such charges were incurred by the customer on the

transactions in question. Respondent instituted the form on which those charges were to be disclosed, and he trained the registered representatives to make those disclosures. The form was meant to be the supervisory tool, and, when the registered representatives filled it out, Respondent expected, and was entitled, to rely on their representations, absent a compliance mechanism by which he could timely confirm whether those sales charges were, in fact, incurred. There was no such mechanism at Firm 1.

5. Inadequate or incomplete documentation of transactions. The only specific allegation in the Complaint is that BC provided the same rationale for purchases on numerous occasions. That allegation is discussed below. On brief, Enforcement asserts that (1) some replacement explanations were merely duplicates of others, (2) information on replacements and sales charges was left blank, and (3) Cover Sheets were internally inconsistent in claiming whether a replacement was involved.

However, the duplicate replacement explanations were on Cover Sheets for two purchase recommendations in October 2000 that related to four individual mutual funds. The replacement explanation listed all four of the purchases that were specified on the two separate Cover Sheets.[35] The duplicate explanation made it more likely that the two recommendations would be scrutinized together.

Because BC attempted to conceal his misconduct, he failed to list contingent deferred sales charges on what appeared to be straight sales of mutual funds. Firm 1 had no compliance mechanism by which Respondent could have determined whether such charges had, in fact, been incurred.

[35] CX-10, pp. 19-22. The front of the first Cover Sheet listed one purchase in the amount of $30,000; the back noted that the dollar amount was $70,000 and specified the four purchases that would total that amount. The Second Cover Sheet listed the remaining three purchases; the back was a duplicate of the first Cover Sheet that specified all four purchases.

Finally, although the fronts and backs of the Cover Sheets were sometimes inconsistent in indicating whether replacements were involved, Respondent had a known disagreement with Firm 1's policy that a "replacement" included funds from a money market account. Firm 1 did not consider the purchase of a new security product to be a replacement when funds came from current income, a certificate of deposit, or a checking or savings account. However, Respondent knew that Firm 2 was of the opinion that a money market fund was "for all intents and purposes, a checking/savings account and should be treated the same way for replacement purposes."[36] Respondent reasonably agreed with Firm 2's view of the issue.

In three cases, BC indicated, consistent with Firm 1 policy, that there were replacements when the source of funds was a money market account. On three others, the front of the Cover Sheet indicated no replacement, but the replacement explanation was filled on the back. As a result, Respondent assumed the wrong box was checked on the front. A purchase in August 2000 was marked as not a replacement when a money market account was listed as the source of funds, and a purchase in January 2002 was similarly described. One purchase in December 2001 was described as not a replacement when the source of funds was "cash reserves"; and the source of funds was missing on one purchase in November 2002. Although these inconsistencies may demonstrate some instances of carelessness on the part of the registered representative, they do not rise to the level of red flags that should have put a supervisor on notice that unsuitable recommendations were being made to the customer, and that BC was misrepresenting the transactions in the Cover Sheets.

[36] RX-3; *cf.* RX-1

6. Similar rationale given to justify numerous switches. In July and August 2000, GL deposited cash in the amount of $55,000.00 and transferred mutual fund shares in the total amount of $96,414.54 to her account at Firm 1. On three occasions in October and December 2000, BC indicated on Cover Sheets that GL was diversifying her holdings in line with her risk/return objectives in six different mutual funds. The total amount to be reinvested was $80,800.00, and the mutual funds that GL had transferred to Firm 1 were identified as the existing investments. GL signed Section A, indicating her agreement with the rationale. There is no argument or evidence in the record that shows why Respondent should have questioned the rationale under the circumstances.

Five months later, in May 2001, BC provided the rationale that GL wished to rebalance her portfolio in line with her investment strategy. The two recommended purchases totaled $14,500.00. The single Cover Sheet is the only one with this particular rationale. Even though the rationale is similar to the earlier explanations that she wished to diversify her holdings, GL signed the back of the Cover Sheet, and Respondent could not reasonably have been expected (1) to remember and compare the rationales on Cover Sheets that BC submitted five months earlier, or (2) question her purchase of two mutual funds with money purportedly coming from money market funds.

Finally, in August 2001, BC recommended the purchase of two funds, each in the amount of $10,000. BC indicated that the source of funds was a money market fund, and the rationale was to develop both an enhanced growth investment strategy and an enhanced bond position. GL signed the Cover Sheet indicating her approval of the rationale. Again, the explanations for the purchases were consistent with earlier ones; but when considered together with the assertion that the source of funds was a money market account, Respondent had no reason to question the explanations themselves. However,

as noted previously, the Hearing Panel does not find Respondent's approval of these purchases and the sales of five mutual funds only four days earlier to be reasonable. The seven transactions were noted on Cover Sheets dated in a single week and involved both the sale of Class B funds and the purchase of Class A funds. Had he questioned the number of transactions, the class of funds involved, and the proximity of the sales to purchases, he would have found that GL incurred sales charges that totaled $2,599.17 during a one-week period. Firm 1's Securities Coordinator's Compliance Manual specifically admonished Securities Coordinators to "review subsequent transactions and their accompanying Cover Sheet for Existing Clients."[37] By failing to follow-up on the red flag raised by the number, nature, and timing of the transactions, Respondent failed to take appropriate action to supervise BC that was reasonably designed to detect and prevent those unsuitable mutual fund transactions, in violation of NASD Conduct Rules 2110 and 3010.

Sanctions

For supervision violations, the NASD Sanction Guidelines suggest a fine of $5,000 to $50,000, and consideration of a suspension in all supervisory capacities for up to 30 business days.[38] The first principal consideration in determining sanctions for this type of violation is whether the respondent ignored red flag warnings that should have resulted in additional supervisory scrutiny and whether the individual responsible for the underlying misconduct attempted to conceal the misconduct from the respondent.[39] Here, with regard to one series of transactions, Respondent should have taken additional supervisory action to question the suitability of BC's recommendations. However, there

[37] CX-2, p. 2.
[38] NASD SANCTION GUIDELINES, p. 108 (2006 ed.). Based on its contention that all allegations in the Complaint have been proved, Enforcement seeks a fine of $15,000 and a suspension of 30 business days.
[39] *Id*.

is no argument or evidence that had Respondent taken that action, BC's misconduct would have been prevented, even in that instance. BC engaged in a course of misconduct that was calculated to conceal his actions from Respondent. He spaced transactions to avoid detection by on-line surveillance, and he fraudulently failed to disclose information that would have revealed readily the unsuitable nature of his recommendations.

The second principal consideration in determining sanctions is the nature, extent, size and character of the underlying misconduct.[40] Although BC's misconduct resulted in financial harm to an unsophisticated customer with limited financial means, the misconduct was discovered and reported by Respondent after meeting with the customer and viewing all of her financial records. As a result, BC was suspended, fined, and ordered to pay restitution to the customer. Respondent's supervisory failure was isolated, not systemic. Moreover, only one registered representative out of the 70 to 90 that Respondent supervised was involved, and only one customer of that registered representative was affected.

The third principal consideration in determining sanctions is the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls.[41] At the outset, the Hearing Panel notes that, at the time of Respondent's supervision of these transactions, the more robust compliance tools that are available today to detect unsuitable mutual fund switching were not then available. Moreover, during and after the conclusion of the transactions at issue, BC was audited by Firm 1's compliance department which did not identify any items of concern with respect to mutual fund transaction recommendations. Although Respondent failed to insure that all paper work was completed to perfection, his implementation of the firm's supervisory

[40] *Id.*
[41] *Id.*

procedures and controls was reasonable, even if those procedures and controls were not sufficient to detect BC's underlying misconduct. Respondent was not responsible for the sufficiency of those procedures and controls.

Nevertheless, the Hearing Panel has found that Respondent's supervision of the August 2001 transactions that were detailed on three Cover Sheets was not reasonable. While he should have followed-up by questioning BC further about those transactions, as noted above, his failure to do so was isolated and not systemic. Under the circumstances, the Hearing Panel concludes that a fine of $5,000 will be sufficient to remediate his supervisory failure and to ensure that his future conduct as a supervisor will conform to the requirements of the securities laws and regulations. Respondent will also be assessed costs in the total amount of $993.00, consisting of a $750 administrative fee and a $243.00 transcript fee.

Conclusion

Respondent is fined $5,000, and assessed hearing costs of $993.00 for failing to take appropriate action to supervise a registered representative that was reasonably designed to detect and prevent unsuitable mutual fund transactions in a customer's account, in violation of NASD Conduct Rules 2110 and 3010.

SO ORDERED.

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Alan W. Heifetz
Hearing Officer
For the Hearing Panel