FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. 2007011915401 Hearing Officer—Rochelle S. Hall **HEARING PANEL DECISION** October 11, 2011

The Hearing Panel dismissed the Complaint following a hearing. The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent violated NASD Conduct Rule 2110 by unethically facilitating wash trades.

Appearances

Colleen Hanrahan, Senior Counsel, and Carolyn Craig, Director, Washington, DC, for the FINRA Department of Enforcement.

Richard J. Grahn and Erin Howard, LOONEY & GROSSMAN LLP, Boston, MA, for Respondent.

DECISION

I. PROCEDURAL HISTORY[1]

The Department of Enforcement filed the Complaint with the Office of Hearing Officers on June 28, 2010, and Respondent filed his Answer on July 23, 2010. The sole cause of the Complaint alleges that by facilitating wash trades for a customer, Respondent acted unethically

[1] Enforcement opened an investigation after receiving a Uniform Termination Notice for Securities Industry Registration ("Form U5) stating that Respondent had been permitted to resign after a Firm inquiry into fixed income cross transactions. The investigation resulted in Enforcement filing the Complaint that initiated this disciplinary proceeding. JX-59 at 7.

and thereby violated NASD Conduct Rule 2110.[2] Respondent denied that his actions were unethical or violated Rule 2110.

The hearing was held in Boston on April 26 and 27, 2011, before a hearing panel composed of the Hearing Officer and two members of the District 11 Committee. Enforcement called five witnesses: Respondent, JP (former Firm branch supervisory and surveillance manager), AW (former Firm international bond trader), DR (Firm bond trader), and AM (former Firm investigator). Respondent testified on his own behalf, but did not call any other witnesses. Enforcement offered 44 exhibits, and the parties offered 60 joint exhibits and 54 stipulations.[3] All of the exhibits were admitted into evidence.[4]

After a thorough review of the record, the Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that Respondent violated Conduct Rule 2110 by unethically facilitating wash trades. Accordingly, the Hearing Panel dismisses the Complaint.

II. Findings of Fact and Conclusions of Law

A. Respondent

Respondent became registered with FINRA in January 1997. He holds Series 7 and 63 licenses. After being employed at several different brokerage Firms, Respondent joined ["the Firm's"] Boston office, where he worked in the Firm's Private Client Services ("PCS") group as

[2] As of July 30, 2007, NASD began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA include, where appropriate, NASD. On December 15, 2008, certain consolidated FINRA rules became effective, replacing parallel NASD rules, and Rule 2110 was re-numbered to Rule 2010. *See* Regulatory Notice No. 08-57, FINRA Notices to Members, 2008 FINRA LEXIS 50 (Oct. 2008). This Decision refers to and relies on the NASD rules that were in effect at the time of the Respondent's alleged misconduct and cited in the Complaint as the basis for the charges against him.

[3] In this decision, "Tr." refers to the transcript of the hearing, "CX" to Enforcement's exhibits, "JX" to the parties' joint exhibits, and "Stips." to the parties' joint stipulations.

[4] Tr. at 385.

a marketing assistant.[5] Respondent specialized in fixed income products. As a marketing assistant, his responsibilities were to "do whatever it took to help increase the general amount of [fixed income] business-- prospecting, idea generation, basically anything to improve the bottom line."[6] Respondent testified that the Firm's bond-trading "training program" consisted of, "Baptism by fire….Just pure observation and trial and error basically. You show up to work, they point you to a computer with a phone, a Bloomberg and a PC, and they say 'go make us money.'" Although Respondent was allowed to place bond orders without obtaining prior authorization, he did not have his own registered representative number; instead, he placed trades using other registered representatives' numbers, and split net commissions with those representatives.[7]

On November 26, 2007, Respondent was permitted to resign from The Firm following an inquiry by the Firm into the bond transactions at issue in this case.[8] Respondent has been employed at another FINRA-registered Firm since January 2008.[9]

B. RIG

RIG, a registered investment adviser, was a long-standing customer of The Firm. RIG managed the investment portfolios of its own institutional customers, many of which were cemeteries and funeral homes.[10] RIG maintained separate accounts at the Firm for each of its clients.[11] The Firm had assigned RIG jointly to two brokers other than Respondent, and the three

[5] Stips. 1.

[6] Tr. at 81.

[7] Tr. at 82-84.

[8] Stips. 1.

[9] JX-59 at 3.

[10] Tr. 32; Stips. 2, 8.

[11] Tr. at 33.

of them split commissions.[12] Those brokers were responsible for the client relationship and equity trading, while Respondent was responsible for RIG's fixed income trading at the Firm.[13]

C. The Firm's Compliance and Wash Trade Policies

During the relevant period, the Firm's policies concerning wash trades were articulated in two compliance manuals. The Firm's PCS Compliance Manual provided:

> Wash Sales
> AEs [Account Executives] may not participate in or assist clients in "Wash Sales." Wash Sales are transactions designed to give the appearance of trading activity without change of beneficial ownership. Wash Sales may not be effected for manipulative intent or to increase apparent trading volume to allow larger sales permitted under Rule 144.[14]

The Firm's USA Core Compliance Manual stated:

> Employees may not effect any other securities transactions intended to manipulate the price of or demand for a security, such as frontrunning (trading ahead of customer transactions), marking the close (effecting transactions at or near the close of trading in order to affect the closing price of the security), withhold or withdraw all or part of another order in the same security, or executing wash sales (transactions in which there is no change in beneficial ownership).[15]

In addition, in December 2006, the Firm distributed an e-mail reminder of the Internal Revenue Service's ("IRS") "Wash Sale Rule," which provided:

> Clients may be interested in selling loss positions to generate capital losses, but may still want to maintain a position in the stock. They must be aware of the wash sale rule. Under the wash sale rule, a loss will be disallowed if within 30 days before or 30 days after the sales date the client buys a substantially identical security. Instead the disallowed loss is added to the basis of the new position.[16]

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[12] Stips. 3.

[13] Tr. at 97.

[14] Stips. 48, 50.

[15] Stips. 49.

[16] Stips. 51.

When Respondent began working at the Firm in 2003, he signed an "Acknowledgement Notice" indicating that he understood that it was his responsibility to know and comply with all of the Firm's policies and procedures as set forth in its compliance manual. The Acknowledgement Notice stated that Respondent should contact his Branch Management or the Compliance Department "for questions or interpretive advice on Firm policies and procedures." The compliance manual set forth a requirement that "[e]mployees should consult with their manager, supervisor and/or a member of the Firm's Legal and Compliance Department when in doubt about the appropriate course of action in a particular situation." The manual also stated that "Employees may not render tax or legal advice to customers."[17]

D. RIG Trade Request

During the morning on October 30, 2007, Respondent received a phone call from RM, who was director of trading at RIG.[18] In their telephone conversation, RM told Respondent that RIG wanted to sell bonds from some of RIG's customer accounts and then have the same accounts repurchase the bonds, in order to take losses for tax purposes.[19] RIG wanted to sell odd-lot (i.e., fewer than one million) corporate and foreign bonds.[20] RIG had not previously requested this type of trade, and Respondent had not been involved in any similar trades in the past.[21]

[17] Stips. 47.

[18] Tr. at 100-101.

[19] Tr. at 34, 104, 185; Stips. 5.

[20] Tr. at 104.

[21] Stips. 5.

Although Respondent recognized that it was his job to try to facilitate RIG's order,[22] he was concerned that the trades might be "wash trades," which were prohibited by the Firm.[23] Respondent was also mindful that it was a violation of the Firm's policy to give any tax advice.[24] RM told Respondent that RIG had done these types of trades before.[25] Nevertheless, he told RM that the trades might be considered wash sales if there was not a change in beneficial ownership.[26] He said he would have to check with his Firm's compliance officer to see if the proposed trades could be done.[27]

E. Timeline of Trading Events

October 30, 2007

1. 11:28 a.m.: After RM's conversation with Respondent, RIG sent Respondent a multi-page fax reflecting the following 45 sell orders for nine separate institutional customer accounts: 21 corporate bond sell orders (AMR (3); El Paso Energy (4); ITT Corp. (2); Petrobras (2); Rite Aid (1); and NALCO Finance (9)) and 24 foreign government bond sell orders (Philippines (5); Turkey (1); Mexico (9); Australia (8); and New Zealand (1)). The same accounts were to sell the bonds to, then repurchase the bonds from, the Firm.[28]

2. 11:31:13 a.m.: Respondent contacted AW, a Firm trader located in London who was responsible for odd-lot sales of Australian and New Zealand government bonds. Because London was five hours ahead of Boston, Respondent called AW to advise her of the proposed

[22] Tr. at 44-45.

[23] Tr. at 45-46.

[24] Tr. at 105; JX-48 at 5.

[25] Tr. at 45.

[26] Tr. at 107.

[27] TR. at pp. 54, 107.

[28] Stips. 6, 7, 8; JX-1 at 1-11.

trades before the close of business in London. This was the first of four recorded telephone calls between Respondent and Willis on October 30, 2007. In this first call, Respondent explained to AW that RIG wanted to sell the bonds, then buy them back in the same accounts for tax loss purposes. "Can I do that?" he asked. She responded, "No." Respondent then asked, "Well, …even with changing beneficial ownership? If I put, like a dollar in it, if I sell you the bond, and you sell them right back?" AW responded, "It's very dodgy doing it in the same account numbers. You'd have to check with your own compliance department…" Respondent sounded surprised, but told AW that he would ask his compliance department about the proposed trades.[29]

3. Right after speaking with AW, Respondent spoke to JP to determine whether the proposed RIG bond transactions could be done as requested. JP was the Branch Supervision and Surveillance Manager in the Firm's Boston office. JP reviewed Respondent's trades every day and had the authority to stop a transaction proposed by Respondent. JP told Respondent that a sale and repurchase of bonds as proposed could be "okay" under certain circumstances—"if there was actual market risk" and a change in beneficial ownership. JP did not tell Respondent how much time the proposed trades needed to be exposed to the market to create risk; in fact, JP did not know what the Firm's policy was on the matter."[30] JP testified that he did not tell Respondent that he could not do the trades.[31]

4. 11:37:58 a.m.: Respondent placed his second call to AW. During this second call, Respondent told AW that his compliance department "said it's okay. They said as long as

[29] Stips. 9, 10; JX-20 at 4-5.

[30] Stips. 11, 15; Tr. at 210-211.

[31] Tr. at 210.

there's, you know, it's two separate transactions, you're taking some kind of market risk, which, you know, you're really not, but it…" AW told Respondent that she would check with her "guys" [compliance department in London] regarding the proposed transactions. Respondent responded, "Yeah, please do."[32]

5. 11:41 a.m.: Respondent contacted DR, a Firm bond trader in New York who was responsible for transactions involving high-yield bonds. Respondent asked DR for prices to sell and repurchase five of the corporate bonds RIG had requested (AMR, El Paso Energy, ITT Nevada, Rite Aid, and NALCO Financial). Respondent proposed selling and repurchasing the bonds for 21 accounts. Respondent referred to the trades as "bond crosses."[33]

6. 11:45 a.m.: Respondent contacted MC, a Firm bond trader in New York who was responsible for transactions involving government bonds for the Philippines and Turkey. Respondent requested prices for "bond crosses" for Philippine government bonds in three accounts and one Turkey government bond.[34]

7. Approximately 11:46 a.m.: AW sent Respondent a Bloomberg message saying, "Give me a ring."[35]

8. 11:46:06 a.m.: In their third telephone discussion, AW told Respondent, "The answer's a big fat no, and my compliance guy would like to know who in your department said that it was fine." Respondent told her it was JP. AW told Respondent, "Your guy may be getting a call from my guy." AW also told Respondent that the proposed trades constitute "tax

[32] Stips. 12, 13.

[33] Stips. 20-25.

[34] Stip. 26-28.

[35] Stips. 16.

avoidance" and "market distortion." Respondent replied, "Well, you know, my guy says yes, your guy says no, so who's right?"[36]

9. Shortly thereafter: JP received a call from a compliance officer in the Firm's London office. JP explained his view that "the trade would be okay if there was actual market risk…If Respondent's customer sold the bond to our desk, they took the bond, took possession, they put it out there, they purchase it out; and then if the customer wanted to purchase the bond back, they would be subject to market risk and price fluctuation."[37]

10. 11:52:16 a.m.: Respondent called AW a fourth time and informed her that "your guy just talked to my guy and it is cool, it is cool what I'm trying to do." In response, AW told Respondent that she would have to get back to him.[38]

11. 11:56:00 a.m.: Respondent sent AW a Bloomberg message identifying the exact Australian and New Zealand bonds involved in the proposed trades. [39]

12. 12:05:00 p.m.: AW responded to Respondent's Bloomberg message, stating, "No can do. Sorry Mate." The orders for the sale and repurchase of the Australian and New Zealand bonds were never put through.[40]

13. Beginning at approximately 12:30 p.m.: Respondent entered orders to sell most of the remaining bonds with the Firm's New York traders. As a result of the orders submitted by Respondent, the Firm purchased bonds from RIG customers, held them for as little as one minute in the Firm's name, and sold them back to the same RIG customers.[41]

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[36] Stips. 14.

[37] Stips. 15.

[38] Stips. 17.

[39] Stips. 18.

[40] Stips. 18, 19.

[41] Stips. 32.

14. 1:55 p.m.: Respondent sent an e-mail to RM recapping the "cross trades" that he had placed that day. Respondent said he was still waiting for prices on the Mexico and Petrobras bonds. He also informed RM that he could not execute the trades in the Australian and New Zealand bonds, saying, "can't help with New Zealand and Australia…"[42]

October 31, 2007

15. In the morning: Respondent placed orders with the Firm's New York bond traders to sell the Mexico and Petrobras bonds to the Firm, and then repurchase the bonds for the same RIG customers. [43]

The Firm's wash sale exception reports captured all of the bond trades placed by Respondent on October 30 and 31, 2007, on behalf of RIG. The Firm then cancelled all of the trades that had not yet cleared.[44] Respondent advised RM of the trade cancellations on November 2, 2007.[45]

DR was the only New York bond trader to testify at the hearing. When discussing market risk, DR was asked whether bond price fluctuations can be almost instantaneous. DR answered, "Let's use AMR because that's a good one. We all understand AMR. I provide the market, 101, 102, and then all of a sudden something hits the tape at the same time I'm providing a market. Let's say we hear a spike in oil, which we can all relate to, okay, and all of a sudden we hear that oil went from $100 a barrel to $115 a barrel; it could affect AMR and what that means is that instantaneously I provided the market, 101, 102, well, all of a sudden, I hang up the phone, I see it come across Bloomberg that oil spiked $15 a barrel; I'm not 101, 102 anymore;

[42] Stips. 33; JX-24.

[43] Stips. 35-44.

[44] Stips. 45.

[45] JX-31.

I'm going to be par 101 because I think airlines are going to get affected by the price of oil and it's going to cause the bond to fall. And that's based on my understanding of what I think is going to happen."[46]

III. Discussion

Enforcement's Complaint alleges only a violation of Conduct Rule 2110. Rule 2110 provides that, "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." There is no claim that Respondent violated any other FINRA rule, regulation or law. In the absence of a violation of another securities rule or law, conduct violates Rule 2110 only if it is found to be "unethical" or committed in "bad faith."[47] For the reasons discussed below, the Hearing Panel found that Enforcement failed to prove by a preponderance of the evidence that Respondent's actions were unethical or committed in bad faith.

Most of the relevant facts of this case are undisputed; however, Enforcement argues that many of the facts were "red flags" that should have alerted Respondent that the proposed trades were inappropriate. Enforcement points out that Respondent himself suspected that the trades were wash sales; that AW advised him that the proposed trades were wash sales; that the Firm's written manuals prohibited wash trades, and that the Firm delivered annual alerts to its employees cautioning them about trades for tax purposes. In Enforcement's view, these were all clear signs.

[46] Tr. at 283-284.

[47] *Kirlin Sec., Inc.* 2009 SEC LEXIS 4168 (December 10, 2009), citing *Thomas W. Heath, III*, Exchange Act Rel. No. 59223(Jan. 9. 2009) 94 SEC Docket 13242, 13246; *Chris Dinh Hartley*, Exchange Act Rel. No. 50031, 2004 SEC LEXIS 1507 (Jul 16, 2004) (citing *Calvin David Fox*, Exchange Act Rel. No. 48731 (Oct. 31, 2003).

The Hearing Panel found that the signs were not at all "clear." First of all, it was not obvious to the Hearing Panel that the Firm's own policies prohibited the trades at issue in this case. The Firm's PCS Compliance Manual defined "wash sales" as "transactions *designed* to give the appearance of trading activity without change of beneficial ownership."(emphasis added).[48] The USA Core Compliance Manual prohibited account executives from executing "securities transactions *intended* to manipulate the price of or demand for a security, such as… executing wash sales (transactions in which there is no change in beneficial ownership)." (emphasis added).[49] Enforcement does not allege that the trades were intended or designed to manipulate or distort the market. And the Firm's e-mail alert simply "reminded" account executives of the IRS's wash sale rule, which has a different purpose than the securities industry's prohibition on wash sales made for manipulative purposes. The IRS's rule does not *prohibit* wash sales. As the Firm's alert stated, "Under the wash sale rule, a loss will be disallowed if within 30 days before or 30 days after the sales date the client buys a substantially identical security. Instead the disallowed loss is added to the basis of the new position." At the same time, the Compliance Manual stated that "Employees may not render tax or legal advice to customers."[50]

The primary dispute in the case is whether Respondent reasonably believed that the transactions resulted in a "beneficial change in ownership" of the bonds. Respondent was unsure, so he consulted with JP, his Branch Supervision and Surveillance Manager. JP was familiar with the Firm's policies and its manuals.[51] He, like Respondent, was responsible for

[48] Stips. 48, 50.

[49] Stips. 49.

[50] Stips. 47, 51.

[51] Tr. at 176.

knowing and complying with the manuals and compliance updates.[52] JP could have told Respondent not to do the trades, but he did not. JP testified that his job was to facilitate customers' transactions, within the parameters allowed by the Firm's policies. So, JP told Respondent that while the trades appeared to be wash sales for tax purposes and that any tax benefit would be nullified, the Firm could not give tax advice.[53] JP then told Respondent that the trades could be transacted as long as there was some kind of market risk and a change in beneficial ownership.[54] He told Respondent that if the Firm purchased the bonds, held them in its name, and exposed them to market risk, then the bonds could be sold back to the same accounts. Although JP said that this had to be done in two separate transactions, with the Firm as the intermediary, he didn't specify how long the Firm was required to hold the bonds.[55]

During cross-examination concerning what he told Respondent, JP admitted that he did not fully explain the required procedures, and that there may have been a misunderstanding with respect to what procedures were required to ensure that the trades were completed appropriately.[56] JP's testimony revealed that he did not fully understand the Firm's requirements for such trades, and he didn't fully explain them to Respondent. It is not surprising, then, that Respondent did not fully understand the Firm's wash trade rules.

Given the information received from JP, the Hearing Panel found that Respondent reasonably believed that the proposed trades were permissible because there was a change in price when the bonds were sold to the Firm and bought back by RIG, and that because the Firm

[52] Tr. at 183.

[53] Tr. at 187; JX-58 at 57.

[54] Tr. at 59, 166.

[55] Stips. at 15; Tr. at 189, 209-210, 224-226.

[56] CX-5 at 10; JX-58 at 56-57.

owned the bonds in its name, albeit for a brief period, there was a market risk, however remote. He reasonably believed that by structuring the trades in this manner, there was a change in beneficial ownership.

Respondent explained his thinking during his second telephone call to AW. Respondent told her that the bonds had to be exposed to market risk, but admitted that if the bonds were to be sold and repurchased soon thereafter they wouldn't be exposed to a great deal of market risk. Respondent testified that AW then interrupted his statement, but that if he had continued his thought, he would have said that nevertheless there was some market risk due to unforeseen events, foreign currency fluctuation and credit risk.[57]

AW testified that the wash sales laws in the United Kingdom are different from those in the United States. She stated that under the laws of the United Kingdom such tax motivated trades were illegal; however, she knew that they might be permissible under the laws of the United States.[58] AW testified that she felt no pressure from Respondent to complete the trades,[59] and the tone of the tape recordings of the telephone conversations show that Respondent did not attempt to press the issue or to go around the London compliance office.

Respondent's reasoning was supported by JP, who testified that certain bonds are extremely liquid and market risk could take place instantaneously.[60] Similarly, DR, who was Enforcement's witness, testified that bond prices could be affected within seconds by market conditions.

[57] Tr. at 61, 111, 160-161.

[58] Tr. at 253.

[59] Tr. at 258.

[60] Tr. at 189.

JP, AW, and DR all testified that in their experience Respondent was always honest and forthright in their dealings with him. None of them believed that Respondent would engage in illicit conduct. Respondent testified that he needed to maintain a good working relationship with the Firm's traders in order to conduct his business, and the witnesses agreed with this assessment. Likewise, the Hearing Panel found Respondent to be credible, and concluded that Respondent acted reasonably in the face of conflicting advice from JP.

The Hearing Panel found that, given Respondent's own confusion about wash trades, and JP's murky guidance, Respondent reasonably believed that by selling the bonds to the Firm, holding them in the Firm's name, however briefly, and then selling them back to the same accounts with a price increase of one basis point, he would establish the required change in beneficial ownership. The Hearing Panel found that although Respondent may have been mistaken, he attempted, in good faith, to facilitate his client's trades while complying with the Firm's policies.

Enforcement failed to prove that Respondent knowingly or intentionally attempted to evade the Firm's policies. Likewise, there is no evidence that he acted with reckless indifference to his responsibilities. He had the authority to process the proposed trades on his own, but sought and obtained the guidance of his compliance officer prior to entering the trades in question. Enforcement did not allege that the proposed trades were placed for the purpose of manipulating or distorting the market.

Having found no violation of any other securities law or Conduct Rule, the Hearing Panel concludes that Respondent has not been shown to have violated Rule 2110 as a result of violating any other law or Rule. Moreover, the Hearing Panel does not find any evidence that he engaged in any bad faith, or unethical conduct. Accordingly, the Complaint will be dismissed.

IV. CONCLUSION

The Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that Respondent violated Conduct Rule 2110. The Complaint is therefore dismissed.

V. ORDER

For the reasons set forth above, the Hearing Panel dismisses the Complaint.[61]

SO ORDERED

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Rochelle S. Hall
Hearing Officer
For the Hearing Panel

Copies to:

Respondent (via overnight courier and first-class mail)
Erin Howard, Esq. (via electronic and first-class mail)
Richard Grahn, Esq. (via electronic mail)
Colleen Hanrahan, Esq. (via electronic and first-class mail)
Carolyn Craig, Esq. (via electronic mail)
David R. Sonnenberg, Esq. (via electronic mail)

[61] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.