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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. 2009018771602 Hearing Officer—LOM **HEARING PANEL DECISION** October 12, 2012

Respondent violated NASD Conduct Rules 2310 and 2110 regarding suitability because he did not have a reasonable basis for recommending that an elderly customer invest approximately 47.6% of her liquid net worth in a single Collateralized Mortgage Obligation. For this violation, Respondent is censured and ordered to pay a fine of $5,000.

Appearances

Laura Leigh Blackston, Senior Regional Counsel, and Andrew A. Favret, Regional Chief Counsel and Vice President, New Orleans, Louisiana, represent the Department of Enforcement.

Steve M. Malina and Beth A. Black, Greenberg Traurig LLP, Chicago, Illinois, represent Respondent.

I. Introduction

The Financial Industry Regulatory Authority, Inc. ("FINRA") Department of Enforcement ("Enforcement") brought this disciplinary action against ["Respondent"], alleging a single cause of action concerning a single securities transaction for violation of NASD Conduct

Rules 2310 and 2110.[1] Enforcement alleges that in March 2007 Respondent violated these Rules by recommending that an elderly widow, VG, invest approximately 47.6% of her net worth in a single Collateralized Mortgage Obligation ("CMO").

A two-day Hearing was held in Dallas, Texas, on May 15-16, 2012, before a three-person Hearing Panel composed of the Hearing Officer, a member of the District 5 Committee, and a member of the District 6 Committee. The Hearing Panel heard testimony of the customer, VG (by video recording), the Respondent, and four other witnesses.[2] Thirty-two joint exhibits were admitted into evidence. The Hearing Panel's decision is based on a review of the entire record.

As more fully discussed below, the Hearing Panel finds that the Respondent's testimony was credible, and that it established that he made an effort to obtain appropriate information from his customer, investigated various investment options, and sincerely believed his recommendation of the CMO was consistent with the investment objectives VG conveyed to him. Nevertheless, the Hearing Panel finds that the recommendation was unsuitable. The concentration of 47.6% of the widow's portfolio in a single CMO that was itself too risky and too complex an investment for any but the most sophisticated and risk tolerant investor was a lapse in judgment. Accordingly, Respondent violated NASD Rules 2310 and 2110, as alleged.

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[1] FINRA, which is responsible for regulatory oversight of securities firms and associated persons who do business with the public, was formed in July 2007 by the consolidation of NASD and the regulatory arm of the New York Stock Exchange ("NYSE"). FINRA is developing a new "Consolidated Rulebook" of FINRA Rules that includes NASD Rules. The first phase of the new Consolidated Rulebook became effective on December 15, 2008. *See* FINRA Regulatory Notice 08-57 (Oct. 2008). Because the Complaint in this case was filed after December 15, 2008, FINRA's procedural Rules apply to the proceeding. The applicable FINRA and/or NASD conduct Rules are those that existed when the conduct in issue occurred. FINRA's Rules (including NASD Rules) are available at www.finra.org/Rules.

[2] The other four witnesses were VG's accountant, the husband of one of VG's nieces, the broker who took over VG's account after Respondent, and a FINRA examiner. None of them was present when Respondent gathered information from VG regarding her financial situation and investment needs and goals or when he presented to her his recommendation of the CMO investment.

II. Findings Of Fact And Conclusions Of Law

A. Respondent

Respondent was trained as an accountant and was first employed in the oil and gas industry, before becoming registered with NASD in September 1993. Respondent became registered through [the "Firm"] in January 2003. He was registered with the Firm during the conduct in issue and until he voluntarily resigned. His securities industry registration was terminated in April 2011.[3]

B. Jurisdiction

FINRA has jurisdiction over this disciplinary proceeding, pursuant to Article V, Section 4 of FINRA's By-Laws, because the Complaint alleges misconduct that occurred while Respondent was a registered representative, and it was filed on October 7, 2011, within two years of the termination of Respondent's registration with a FINRA-registered firm.

C. NASD Rules In Issue

NASD Rule 2310 requires that a registered representative who makes a recommendation for a securities transaction have "reasonable grounds" for believing that the recommendation is suitable for the customer. The Rule provides that the "reasonable grounds" be developed "upon

[3] Jt. Ex. 22, pp. 3 and 7 of 39 (Central Registration Depository ("CRD"), composite information for Respondent); Hearing Tr. (Respondent) at 39-45. On Respondent's Form U5 (Uniform Termination Notice For Securities Industry Registration), the Firm reported that he was "permitted to resign because of decreased effectiveness due to customer complaints." Jt. Ex. 22, p. 35 of 39. At the Hearing, Respondent acknowledged that he left the industry because of customer complaints and described them. The complaints included an instance of being slow to respond to email, an instance where he declined to buy stocks at the instruction of a customer's brother, who had limited trade authorization, until the brother came in to discuss and approve specific investments, and an instance where a client who sold a bond in 2007 against his advice regretted the sale in 2008 and blamed him. This proceeding is his only pending formal issue. Hearing Tr. (Respondent) at 138-42. Respondent has no disciplinary history reported on his CRD. Jt. Ex. 22.

Respondent currently runs a franchise business but would like to reenter the securities business. He found that the pendency of this proceeding made it difficult to secure employment in the securities industry. Hearing Tr. (Respondent) at 47-48.

the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[4]

Pursuant to this Rule, before effecting any customer transaction, a registered representative must make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives, and any other information considered reasonable in making the recommendation. This customer-specific suitability turns on the particular facts and circumstances of the customer's situation.[5] Only with knowledge of the particular customer's situation can the registered representative determine, as the suitability rule requires, that the recommendation is in the customer's best interests.[6]

The registered representative must also reasonably investigate the recommended security. One can only determine whether a particular investment would be appropriate in light of the investor's circumstances and objectives if one also has an adequate understanding of the investment he or she is recommending. This reasonable diligence as to the recommended security is sometimes referred to as "reasonable-basis" suitability.[7]

[4] NASD Rule 2310 applied at the time Respondent recommended the CMO to the widow. It has been superseded by FINRA Rule 2111, but NASD Rule 2310 is available on FINRA's website under "Retired NASD Rules."

[5] *See, e.g., Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) (a recommendation should "serve [the] client's best interests" and be "consistent with the client's financial situation and needs").

[6] *Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'"); *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006) ("[A] broker's recommendations must be consistent with his customers' best interests.").

[7] *In re Cody*, Exch. Act Rel. 64565, 2011 SEC LEXIS 1862, *26-32 and nn. 8-16 (May 27, 2011), *aff'd* , __ F.3d __, 2012 U.S. App. LEXIS 18914 (1st Cir. Sept. 7, 2012). *See also Hanly v. SEC*, 415 F.2d 589, 595-596 (2d Cir. 1969); *Dep't of Enforcement v. Siegel*, No. C05020055, 2007 NASD Discip. LEXIS 20, at *38 (NAC May 11, 2007).

NASD Rule 2110 requires the observance of "high standards of commercial honor and just and equitable principles of trade." This Rule applies to all business-related conduct.[8] It is well-established that a violation of other NASD rules is inconsistent with the "high standards" required by NASD Rule 2110.[9] Accordingly, a violation of NASD Rule 2310 is also a violation of NASD Rule 2110.[10]

D. CMOs Generally

CMOs are a type of bond or debt security. "CMOs are typically created by national securities firms from a pool of mortgage loans issued by governmental agencies such as the Federal Home Loan Mortgage Corporation. The cash flow from the underlying loans is redirected into different types of bonds which are then sold to investors."[11]

CMOs have long been a concern of FINRA and its predecessor, NASD, because they are complex and varied instruments. The cash flow from the underlying pool of loans can be packaged into a number of different "tranches" with different characteristics, different patterns of repayment, and different degrees of risk. The value and liquidity of CMOs can vary in relation to changes in interest rates, repayment rates, and other factors.[12] "CMOs are less uniform than

[8] *Dep't of Enforcement v. Trende*, No. 2007008935010, 2011 FINRA Discip. LEXIS 54, *11 and nn.12 & 13 (OHO Oct. 4, 2011).

[9] *See Thomas W. Heath, III*, Exchange Act Rel. No. 59223, 2009 SEC LEXIS 14 (Jan. 9, 2009), *aff'd*, 586 F.3d 122 (2d Cir. 2009), *cert. denied, Heath v. SEC*, 2010 U.S. LEXIS 3029 (U.S. Apr. 5, 2010). *See also Dep't of Enforcement v. CMG Inst. Trading, LLC*, No. 2006006890801, 2010 FINRA Discip. LEXIS 7, at *3 n.2 (NAC May 3, 2010).

[10] *Dep't. of Enforcement v. Evans*, No. 2006005977901, 2011 FINRA Discip. LEXIS 36, at *22 (NAC Oct. 3, 2011) ("A violation of NASD Rule 2310 also constitutes a violation of NASD Rule 2110."); *James B. Chase*, Exchange Act Rel. No. 47476, 2003 SEC LEXIS 566, at *21 n.28 (Mar. 10, 2003) (same); *Clinton Hugh Holland, Jr.*, Exchange Act Rel. No. 36621, 1995 SEC LEXIS 3452, at *12 n.20 (Dec. 21, 1995) (same), *petition for review denied*, 105 F.3d 665 (9th Cir. 1997) (Table).

[11] Community Hospital of Springfield and Clark County, Inc. v. Kidder, Peabody & Co., 81 F. Supp. 2d 863, 866 (S.D. Ohio Nov. 1999).

[12] *Id.* at *867. *See also* Notice To Member 93-73 ("NTM 93-73") (available on-line in the FINRA Manual).

traditional mortgage-backed securities and more expensive to trade. It is also harder to obtain current pricing information."[13]

CMOs include Principal-Only ("PO") and Interest-Only ("IO") tranches, as well as different types of floating-rate tranches. PO tranches are structured so that investors receive only principal payments generated by the underlying collateral. CMOs with PO tranches also have IO tranches. The IO tranches receive cash flow from interest payments generated by the underlying collateral. PO market values are extremely sensitive to prepayment rates on the underlying bonds, increasing in value if interest rates are falling and prepayment rates accelerate, and declining in value if interest rates rise and prepayments slow. IOs work in the opposite way from POs, increasing in value as interest rates rise and prepayment rates slow. They are often used to hedge against interest rate risk. If prepayment rates are significantly higher than expected, there is even a potential that an IO investor could receive less cash back than initially invested.[14]

E. Respondent's Recommendation And Sale Of A CMO To VG, An Elderly Widow

In spring of 2007, VG, then a 91-year-old widow, had an investment account with Smith Barney.[15] The account totaled a little over $800,000 in value and was invested approximately half in equities (three stocks) and half in mortgage-backed bonds (cash flow generated by pools of mortgages) commonly referred to as Ginnie Maes (eight Ginnie Maes). VG needed $3,000 a month for living expenses.[16]

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[13] NTM 93-73.

[14] NTM 93-73. *See also SEC v. Betta*, 2011 U.S. Dist. LEXIS 108429, at *6-7 (September 19, 2011) ("IOs exhibit much greater price variability than the underlying portfolio of mortgages from which they were created….IOs have less liquidity than other CMO classes because there is a limited market for them….IOs are unusually risky CMOs and are considered by some market professionals to be among the riskiest of the mortgage securities….IOs are one of the few types of CMOs for which there is a reasonable chan[c]e that investors might never recoup their initial investment….").

[15] Hearing Tr. (Respondent) at 57-68, 128.

[16] Hearing Tr. (Respondent) at 57-68.

VG also had a bank account at a bank affiliated with the Firm. While at the bank, she expressed unhappiness with the Smith Barney account to a bank employee. The bank employee referred VG to Respondent, who spoke to her briefly on the telephone to set up a meeting.[17]

Respondent testified that his overall impression of VG's mental faculties was that "she was sharp."[18] When he first met with the widow she was living in the independent section of a retirement community. She met him in a common area of the facility without any attendant or assistance. She did not use a walker. They talked for about an hour. VG did not need a break.[19]

As Respondent had asked her to do when he spoke to on the telephone, VG brought her Smith Barney account statement to the meeting with Respondent. VG talked about the account statement in a way that led Respondent to believe that she understood what was in the account.[20] Her primary concern was how to generate $3,000 per month for her living expenses without reducing her principal.[21] Respondent's contemporaneous notes taken at the time he spoke with VG reflect that she was unhappy with her existing investment account at the other firm because she was "[n]ot earning enough income."[22] He thought she was "very clear" in their hour-long conversation about what was in the account and her concern.[23] Respondent testified that "she showed me her three stocks. She showed me the Ginnie Maes. And there's eight of them, I believe, so I think it took over a page to show them, but pointed out that most of them had paid back most of their principal. And basically, that was the gist of why she wanted to consider moving, is she felt like the account itself wasn't generating enough income to be paying her the

[17] Hearing Tr. (Respondent) at 57-58.

[18] Hearing Tr. (Respondent) at 62.

[19] Hearing Tr. (Respondent) at 59-61.

[20] Hearing Tr. (Respondent) at 59-68, 86.

[21] Hearing Tr. (Respondent) at 68, 73-74.

[22] Hearing Tr. (Respondent) at 79-80; Jt. Ex. 3.

[23] Hearing Tr. (Respondent) at 86.

$3,000 she was getting. In other words, she knew the $3,000 was coming out of – mostly out of principal at that point."[24] He further testified that there was no doubt in his mind that VG understood how her account was invested at Smith Barney and how it was performing.[25]

Respondent sat with VG as they together filled out the paperwork to open an account with the Firm. She told him her most important objective was income. She reiterated that she needed her portfolio to generate $3,000 in income per month. He discussed CMOs generally as a possible investment because they worked in the same way as the Ginnie Maes and she was comfortable with the Ginnie Maes. He also discussed closed-end funds and possibly selling some of her equity position. VG told him that the stock had a low cost basis and that there would be tax consequences when it was sold. He suggested that the impact could be decreased and spread out by selling over time instead of all at once. Respondent made no purchase recommendation of any specific security in the first meeting.[26]

At the end of the meeting, Respondent asked if there was anyone he could call to involve in the consideration of what to do. He particularly asked about family. VG referred him to her accountant.[27] He and VG's accountant traded calls, and he eventually had a telephone conversation with her, but only after he had investigated options for VG and made the recommendation to invest in the CMO.[28]

Respondent testified that after his first meeting with VG he investigated various possible investments for VG, including not only CMOs and closed-end funds, but corporate bonds, treasuries, and Certificates of Deposit ("CDs"). Bonds were trading at a premium and were

[24] Hearing Tr. (Respondent) at 62-63.

[25] Hearing Tr. (Respondent) at 67-68.

[26] Hearing Tr. (Respondent) at 70-78.

[27] Hearing Tr. (Respondent) at 78.

[28] Hearing Tr. (Respondent) at 86-87, 98-103.

paying interest every six months instead of monthly. CDs could not generate the income VG wanted. In the course of his research, Respondent talked with the Firm's bond trader and with the person at the Firm responsible for researching CMOs. He came to the conclusion that a CMO was best suited to meet VG's needs.[29]

The Firm limited the securities that a registered representative could sell to customers, and generally a Firm representative could only sell bonds that were A-rated or higher. Respondent never saw the Firm offer a CMO that was less than triple-A-rated. The Firm would not make available for sale any CMO with exposure to the subprime market.[30] Respondent testified that the Firm had a "conservative" culture that was protective of its generally affluent customers.[31]

After VG's assets were transferred to the Firm, Respondent again talked to the person responsible for CMOs. The only CMO she had to offer was a Countrywide CMO that was triple-A-rated. They discussed it and concluded that it was a product that matched the conservative nature of the Firm clients.[32] Respondent examined a document that provided information about the loans in the CMO pool. He considered the loan-to-value ratio conservative.[33]

When Respondent met with VG a second time, two or three weeks later, he discussed his recommendation of the Countrywide CMO and the various alternatives he had considered. He also discussed how the CMO would fit into her total portfolio and his plan for selling some of the equities she currently held so that she could reinvest in closed-end funds that would contribute more monthly income. He provided her a written document that explained how a CMO works

[29] Hearing Tr. (Respondent) at 81-82, 87-89.

[30] Hearing Tr. (Respondent) at 54-56.

[31] *Id.*

[32] Hearing Tr. (Respondent) at 88-89.

[33] Hearing Tr. (Respondent) at 90-92; CX 21.

and the risks involved in a CMO investment. He asked her several times as he went along in his presentation whether she understood. Every time that he would stop and ask, she said yes, she understood.[34]

VG purchased the Countrywide CMO in spring of 2007. Respondent described it at the Hearing as an IO (interest only) tranche that paid interest monthly for some years before starting to pay back principal.[35] It was the twelfth tranche out of around twenty.[36] It generated approximately $2,000 monthly, and when combined with the other investments in her portfolio, she received around $4,000 monthly.[37] The CMO paid 6% interest and was still paying that rate at the time of the Hearing.[38] However, as the financial crisis developed in 2008 and Countrywide itself fell into disrepute, the resale value of the CMO fell.[39]

Respondent received around $800 as his commission on the transaction. The Firm did not pay him more to sell CMOs than to sell other possible investments. He was not monetarily incented by the Firm to sell CMOs.[40] CMOs were not a large part of Respondent's business. He had only four of five other customers in CMOs, typically people at retirement age looking for

[34] Hearing Tr. (Respondent) at 94-98.

Enforcement introduced an email Respondent wrote to a colleague at the Firm after his first telephone call to VG to undercut his testimony that he believed VG was capable of understanding the discussion of her investments and his recommendation. In the email, he wrote, "Poor lady, I think she is the type that other people can take advantage of." Jt. Ex. 4. This email was written after a two-minute telephone call, before Respondent had met VG in person. Respondent testified at the Hearing that she had expressed the idea in that first telephone call that she would stay with Smith Barney because the broker was a "nice guy" and that concerned him. "[D]epending on the broker, he could take advantage of her." Hearing Tr. (Respondent) at 84-85. He testified that after his hour-long meeting with VG in person and how she discussed the stocks and Ginnie Maes in her account and her concern regarding monthly income, he had no concern that she did not know what she was talking about. Hearing Tr. (Respondent) at 86.

[35] Hearing Tr. (Respondent) at 118-19.

[36] Hearing Tr. (Respondent) at 120.

[37] Hearing Tr. (Respondent) at 108.

[38] Hearing Tr. (Respondent) at 109-10; Hearing Tr. (JP) at 236-37.

[39] Hearing Tr. (JP) at 236-37.

[40] Hearing Tr. (Respondent) at 103-04.

monthly income to help them to budget better. None of them ever complained about their CMO investments.[41]

F. Subsequent Events

Respondent sent monthly statements of VG's account to her and to her accountant.[42] Late in 2007, VG told her accountant she was unhappy with the account, and the accountant obtained VG's authorization to ask a broker at another firm, ["JP"], to review VG's December 2007 statement and make recommendations.[43] JP and the accountant's firm referred each other business.[44] JP was the accountant's own broker as well.[45]

JP testified that he reviewed VG's account in early to mid-January 2008 and became concerned about the concentration in the Countrywide CMO. Among other things, he testified, he thought that the long-term exposure to possible rising interest rates would exert a downward pressure on the value over the thirty-year life of the instrument which "the heirs would then be dealing with a lower – lower price value."[46] He communicated his concerns to VG's accountant.[47]

VG had three nieces. The 62-year old husband of one of the nieces, RH, testified that he and another niece's husband held a Power-of-Attorney for VG but had been unaware of her transfer of her account from Smith Barney to Respondent and the Firm. In January 2008, he became more involved in VG's affairs.[48]

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[41] Hearing Tr. (Respondent) at 45-46, 52.

[42] Hearing Tr. (Respondent) at 99; Hearing Tr. (accountant) at 162.

[43] Hearing Tr. (accountant) at 162-63, 184.

[44] Hearing Tr. (accountant) at 183-84.

[45] Hearing Tr. (accountant) at 183.

[46] Hearing Tr. (JP) at 236.

[47] Hearing Tr. (JP) at 237-38.

[48] Hearing Tr. (RH) 204-07, 209-10.

In January or February 2008, JP met with VG, her accountant, and RH. JP said he viewed RH as VG's overseer.[49] JP criticized the investments in VG's account, particularly the concentration in the Countrywide CMO. With respect to the Countrywide CMO, they agreed on a plan for an "orderly exit" in which they would slowly reduce the position over a twelve-month period.[50]

With respect to VG's mental capacities at that time, JP testified that "[s]he seemed attuned to the situation." He also said, however, that he "could never have walked out of a meeting like that" and would never have taken some action at VG's direction "without some approval from her circle, [RH, the accountant], whoever her circle was."[51]

VG's account was transferred to JP after that meeting.[52] A portion of the CMO was sold for a loss of approximately 15% of the principal.[53] JP recommended that VG and her family to ask the Firm for rescission or some other kind of recovery.[54] When the Firm seemed unlikely to act on that request, VG filed a complaint in arbitration. The Firm eventually settled that claim.[55]

G. Credibility

VG provided video testimony recorded in 2012, when she was 97 years old. By that time, she did not remember the events in issue and did not demonstrate a current mental capacity

[49] Hearing Tr. (JP) at 239. JP believed that RH was the executor for VG's estate. Hearing Tr. (JP) at 239-240. RH provided some of the information necessary to open an account for VG with JP's firm, and gave direction regarding investment objectives. Hearing Tr. (JP) at 257-58; Jt. Ex. 29. RH made decisions such as how money would be distributed from the VG's account once it was transferred to JP's firm. Hearing Tr. (JP) at 257-58. JP testified that he confirmed objectives and risk tolerance with RH and the accountant, as well as VG. Hearing Tr. (JP) at 242.

[50] Hearing Tr. (JP) at 236-38, 242-44.

[51] Hearing Tr. (JP) at 246.

[52] Hearing Tr. (Respondent) at 114-15.

[53] Hearing Tr. (JP) at 243-44. Eventually, all of the CMO in VG's account was sold for approximately 80-cents-on-the-dollar. Hearing Tr. (JP) at 255-56.

[54] Hearing Tr. (JP) at 248-49.

[55] Hearing Tr. (Respondent) at 121; Hearing Tr. (JP) at 249-50, 256-57.

to understand a complex investment like a CMO. However, even at 97, she appeared poised and well-spoken. She seemed to have retained what sounded like coaching when she reiterated that she "wasn't qualified to make a good judgment about that" in answer to certain questions, particularly relating to her concern that her account was not paying enough income each month.[56]

Respondent was not the only witness who testified that VG's mental capacity five years before, at the time of the events in issue, was capable. Her nephew-in-law said his impression of her mental capacity at that time was "that she [was] pretty much hitting on all cylinders." He said she was "very mobile" and "had only stopped driving maybe, you know, just a year or two before that." He described her as "active" and said she could hold a "good conversation." He said that "she was still cognizant of the – of the bottom line."[57]

The Hearing Panel does not view VG's 2012 testimony as rebutting the Respondent's testimony as to his conversations with her in 2007. Respondent's testimony shows that he diligently attempted to ascertain VG's financial situation and investment objectives, that he sincerely believed that she understood her investments and her options, and that he thought the CMO met her needs. The Hearing Panel finds that Respondent was credible. He answered

[56] Jt. Ex. 32, p. 28 of 72.

[57] Hearing Tr. (RH) at 202-03.

difficult questions (such as questions about other customer complaints) forthrightly and without dissembling.[58]

H. Respondent's Recommendation Was Unsuitable And A Violation

Unfortunately for Respondent, however, the Hearing Panel's decision does not turn simply on Respondent's credibility and sincerity. Even an apparently well-intended recommendation meant to achieve the investor's stated goals can be unsuitable for that investor in light of an objective analysis of the circumstances. In making an investment recommendation, a registered representative cannot rely only on the customer's stated desires but must form a reasonable, independent judgment regarding the particular facts and circumstances and the appropriate type of investment recommendation. The Securities and Exchange Commission ("SEC") has held, for example, that even if a customer with limited means is "willing, or even eager, to pursue 'growth' as [the registered representative] understood it, it was [the registered representative's] duty to advise [the customer] against that pursuit to the extent that it was incompatible with her acknowledged needs."[59] The SEC similarly has held that a customer's desire to "double her money" does not relieve a registered representative of the duty to recommend only suitable investments.[60] The SEC has explained that even if an investor

[58] Respondent and VG's accountant both testified about a telephone call they had after Respondent recommended the CMO to VG. They had different memories of the conversation. In light of the Hearing Panel's decision, which is based on the degree of concentration and the inherently risky nature of the CMO, their conversation and their differing recollections would not make a difference to the outcome of this proceeding. It is unnecessary to make any findings regarding their conflicting testimony.

VG's accountant also testified that by January 2008 she believed VG did not have the capacity to understand a CMO. Hearing Tr. (accountant) at 165. The accountant acknowledged, however, that she was not a part of the conversation between Respondent and VG when he recommended the CMO. Hearing Tr. (accountant) at 178. The Hearing Panel finds that the accountant's opinion of VG's mental capacity almost a year after Respondent discussed the CMO with VG does not provide a basis for discounting Respondent's testimony regarding his conversations with VG in spring of 2007.

[59] *James B. Chase*, Exchange Act Rel. No. 47476, 2003 SEC LEXIS 566, at *20 (Mar. 10, 2003) (found violation of NASD Conduct Rules 2310 and 2110 for recommending and effecting transactions resulting in 100% concentration in single company's stock).

[60] *Rafael Pinchas*, Exchange Act Rel. No. 41816, 1999 SEC LEXIS 1754, at *22 (Sept. 1, 1999).

understands the broker's recommendations and does determine to follow them, the broker still has an "obligation to make reasonable recommendations" that are "consistent with [the customer's] financial situation and needs."[61]

In this case, according to Respondent's unrebutted testimony, VG declared that her goal was to obtain $3000 per month income without drawing down principal. Respondent's recommendation of the CMO was designed to achieve that goal. However, several aspects of the recommendation made it inappropriate regardless of VG's stated goal or her understanding of what Respondent told her about the CMO.

First, the degree of concentration in the single CMO – 47.6% of VG's portfolio – was too high. Respondent's own testimony supports this finding. At the time he discussed VG's account with her and made the recommendation, half her portfolio was invested in three stocks and half was invested in eight Ginnie Maes. In discussing her account with her, Respondent expressed concern with the degree of concentration on the equity side of her portfolio, where approximately half of her portfolio was invested in the stock of just three companies.[62] In light of Respondent's own conclusion with respect to the equity investments, investing the other half of her portfolio in a single security was, on its face, too high a concentration.[63] Furthermore, although Respondent testified that he thought of the CMO as simply replacing the equivalent amount of Ginnie Mae bonds in VG's portfolio,[64] he replaced eight different bonds with just one.

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[61] *Jack H. Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *14 (Feb. 10, 2003).

[62] This testimony contributed to the Hearing Panel's finding that Respondent was credible. Even though this testimony did not help his defense, he was forthcoming about it.

[63] Respondent testified that the reason he expressed concern about the degree of concentration in her equity holdings was that she was not generating enough income from that portion of her portfolio and that stocks were subject to volatility. While the investment in the CMO may have generated more income than the equities, the CMO also carried risks, as discussed below.

[64] Hearing Tr. (Respondent) at 149.

He did not merely maintain the existing degree of diversification, but he substantially increased the degree of concentration in VG's portfolio.

Respondent testified that he was unaware of any SEC or FINRA Rule or guidance establishing an exact limit on the amount of concentration appropriate for any particular security or type of customer.[65] Because suitability depends on all the facts and circumstances, however, arbitrary numerical cut-off points cannot be applied. A registered representative must exercise reasonable judgment as to the level of concentration appropriate in a customer's account.

Second, the CMO itself was inappropriate for VG. As recently noted in another FINRA disciplinary proceeding, "For nearly 20 years, FINRA has advised its members that CMOs are not appropriate for ordinary investors."[66] With respect to IOs in particular, members have long been informed that IOs may be sold "only to a sophisticated investor maintaining a high-risk profile."[67] Regardless of VG's desire for a steady monthly income of $3,000 and her general understanding of what Respondent told her about the CMO in issue, nothing in the record suggests that she was a "sophisticated investor" who had a "high-risk profile." Her desire to preserve her principal and to create a steady income stream, in fact, shows the opposite.

The Hearing Panel finds that although Respondent demonstrated a general understanding of CMOs, he relied too heavily on his Firm's supervision and selection of investments for marketing and sales when he recommended the CMO in issue here. In uncontroverted

[65] Hearing Tr. (Respondent) at 125. The FINRA examiner testified that she considered 47% in any one security too high a concentration and *per se* unsuitable. Hearing Tr. (examiner) at 333. The Hearing Panel did not rely on that testimony but, rather, examined all the facts and circumstances in coming to the conclusion that the recommendation here was unsuitable.

[66] *Dep't of Enforcement v. Brookstone Securities, Inc.*, No. 2007011413501, 2012 FINRA Discip. LEXIS 52, at *87 (May 31, 2012), *appeal docketed* (June 12, 2012).

[67] NTM 93-73.

testimony, Respondent testified that the Firm's clientele was "very conservative"[68] and that the Firm had a "culture of just vetting everything, [to] make sure it fit a [Firm] client profile."[69] He repeated throughout his testimony that the Firm had "vetted" the CMO.[70] Nothing in his testimony demonstrates an understanding of the particular risks associated with the particular IO tranche that he sold VG.

III. Sanctions

The first step in considering sanctions is to examine the FINRA Sanction Guidelines ("Sanction Guidelines") for the particular type of violation. For a suitability violation of NASD Conduct Rule 2310, the Sanction Guidelines suggest a fine ranging from $2,500 to $75,000 and a suspension ranging from ten business days to one year. In an egregious case a longer suspension may be appropriate.[71]

The second step is to examine the Principal Considerations relevant to this type of violation.[72] Several Principal Considerations are relevant here. Respondent has no prior disciplinary history, and, while that is not a mitigating factor, it does mean there is no aggravating factor of past misconduct.[73] Respondent did not engage in a pattern of misconduct[74] or misconduct that extended over a long period of time.[75] Rather, the violation was a single incident that occurred in a matter of a few weeks. The record contains no indication that

[68] Hearing Tr. (Respondent) at 54-55.

[69] Hearing Tr. (Respondent) at 56.

[70] Hearing Tr. (Respondent) at 54-56, 96, 126, and 145.

[71] FINRA Sanction Guidelines (2011), available at www.finra.org/oho (then follow "Enforcement" hyperlink to "Sanction Guidelines") at 94.

[72] *Id.*

[73] Principal Consideration 1 and n.1, Sanction Guidelines at 6.

[74] Principal Consideration 8, Sanction Guidelines at 6.

[75] Principal Consideration 9, Sanction Guidelines at 6.

Respondent engaged in any deception regarding the conduct in issue.[76] Rather, there is evidence that he conferred with the person at his Firm responsible for CMOs about his recommendation to VG. The particular recommendation did not give rise to monetary gain for Respondent beyond a modest one-time commission.[77] It is abundantly clear that Respondent did not intend to harm the customer.[78] On the other hand, VG was harmed by the recommendation and purchase of the CMO, because the security was high-risk and highly illiquid. Whether or not the inherent risks of the CMO were ever realized,[79] it was a type of security that could not easily be sold if her circumstances changed or she died and the heirs had different investment needs and objectives.

The third step is to review the General Principles applicable to all violations.[80] General Principle No. 1 requires that a sanction should be designed to deter future misconduct and improve overall business standards in the securities industry.[81] General Principle No. 3 requires that a sanction be "remedial" and not punitive.[82] It authorizes FINRA to impose a broad array of sanctions, ranging from mild to severe, and including a censure as well as a suspension or bar, or "any other fitting sanction."[83] The Sanction Guidelines are suggestions, not mandates.[84]

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[76] Principal Consideration 10, Sanction Guidelines at 6.

[77] Principal Consideration 17, Sanction Guidelines at 7.

[78] Principal Consideration 13, Sanction Guidelines at 7.

[79] The record showed that pre-payment risks and other inherent risks of the instrument never developed. Hearing Tr. (Respondent) at 123-25. Enforcement endeavored to show that VG had been harmed because the security was eventually sold in pieces for less than VG paid for it. Respondent endeavored to show that if VG had retained the security she would still be receiving a stream of income at the 6% rate. Suitability, however, is evaluated as of the date of the recommendation, based on the facts and circumstances at that time. *In re Cody*, Exchange Act Rel. 64565, 2011 SEC LEXIS 1862, at *37 and n.32 (May 27, 2011), *aff'd*, __ F.3d __, 2012 U.S. App. LEXIS 18914 (1st Cir. Sept. 7, 2012) (citing cases).

[80] Sanction Guidelines at 2 ("Adjudicators should design sanctions that are significant enough to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to modify and improve business practices.").

[81] Sanction Guidelines at 2.

[82] Sanction Guidelines at 3.

[83] *Id.*

[84] Sanction Guidelines at 3.

In this case, the Hearing Panel believes that it is a sufficiently remedial sanction to censure Respondent and impose a fine of $5,000. The Sanction Guidelines indicate that a censure should not be imposed where a fine of $5,000 or less is imposed *and* the violation falls within one of the listed violations on Schedule A of the Sanction Guidelines.[85] The violations on Schedule A generally are technical violations and do not include any suitability violation.[86] Accordingly, the Hearing Panel believes that the censure is appropriate, despite the relatively modest size of the monetary sanction, because a recommendation that puts a customer at substantial risk is a serious violation even if the violation lacks any venal quality. Members and registered representatives are responsible for attending to the analysis of the suitability of a particular investment for a particular customer with great care.

IV. Order

The Hearing Panel finds that Respondent made an unsuitable recommendation of a CMO to an elderly widow in violation of NASD Rules 2310 and 2110. Accordingly, Respondent is censured and fined $5,000, and ordered to pay costs in the amount of $3773.40, which includes a $750 administrative fee and the cost of the transcript.[87] **The fine and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter.**

Lucinda O. McConathy
Hearing Officer
For the Hearing Panel

[85] Sanction Guidelines at 9 and Schedule A at 106.

[86] *Id.*

[87] The Hearing Panel has considered and rejects without discussion any other arguments made by the Parties that are inconsistent with this decision.