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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RESPONDENT Respondent.	Disciplinary Proceeding No. 20070094013 Hearing Officer – SNB **EXTENDED HEARING PANEL DECISION** April 4, 2013

The Hearing Panel finds that Respondent exercised discretion by purchasing municipal bonds in customer accounts after his firm prohibited discretionary trading, in violation of MSRB Rule G-19(d). For this violation, Respondent is fined $5,000. Enforcement failed to prove that Respondent engaged in excessive trading and churning, in violation of MSRB Rules G-17, G-19(c), and G-19(e); made material misrepresentations to customers, in violation of MSRB Rule G-17; or exercised discretion by purchasing equities in a customer's account, in violation of NASD Rules 2510(b) and 2110. Accordingly, these charges are dismissed.

Appearances

Ronald W. Sannicandro, Esq., Adeline Liu, Esq., and Danielle I. Schanz, Esq., for the Department of Enforcement.

Sylvia M. Scott, Esq., Samuel A. Keesal, Jr., Esq., and Michele R. Fron, Esq., for Respondent.

DECISION

I. INTRODUCTION

This case raises three issues: whether Respondent, a broker specializing in sophisticated municipal bond investing techniques for high net worth customers, engaged in quantitatively unsuitable (excessive) trading and churning of municipal bonds in customer accounts, made material misrepresentations regarding commissions, and exercised discretion in customer accounts when his firm prohibited discretionary trading. FINRA Staff investigated the facts related to this matter after customer AT complained to Respondent's firm, UBS Financial Services Inc. ("UBS" or the "Firm"), that Respondent was charging a higher commission on bond transactions than he had represented.

On December 1, 2010, the Department of Enforcement filed a six-cause Complaint. On December 13, 2010, Enforcement filed an Amended Complaint with the same causes. On January 26, 2011, Respondent filed an Answer to the Amended Complaint, denying the allegations and requesting a hearing. A 14-day hearing concluded on March 29, 2012. The parties completed filing post hearing submissions on July 11, 2012.

After careful consideration, the Hearing Panel concludes that Respondent exercised discretion by trading bonds in customer accounts after the Firm prohibited discretionary trading, thereby violating MSRB Rule G-19(d). On the remaining charges – excessive trading, churning, misrepresentations, and discretionary trading of an equity security in violation of Firm policy – the Hearing Panel concludes that Enforcement failed to meet its burden of proof.[1]

[1] Following the hearing, Respondent filed a motion to substitute a redacted version of Complainant Exhibits CX-54 and CX-54A to omit the names, but not the account numbers of customers who were not referenced in the Complaint. For good cause shown, this motion is granted.

II. FINDINGS OF FACT

A. Respondent's Background

Respondent first registered with a FINRA member firm in 1972, and has been continuously registered since that time.[2] Respondent was registered as a General Securities Representative with UBS between January 2002 and September 2006, and was registered there during the alleged violations.

B. Enforcement Failed to Prove that Respondent Engaged in Excessive Trading and Churning

The Amended Complaint alleges that the trading in ten of Respondent's customer accounts was quantitatively excessive and also constituted churning. The claim focused on 277 trades over a four-year period (selected from a total of 27,900 trades). However, the evidence offered at the hearing, including the testimony of Respondent and his expert witness, established that Respondent's sophisticated portfolio management strategies were reasonably designed to benefit the customers, in light of their unique financial profiles and investment objectives, and they were generally effective. In addition, commonly applied measures – the turnover rates and cost-to-equity ratios – were quite low, which is inconsistent with the charge of excessive trading. And more broadly, the overall volume of trading across Respondent's customer base was low. Finally, the evidence offered at the hearing did not support Enforcement's allegation that Respondent's trading caused losses in the customer accounts.

1. The Customers' Financial Profiles and Investment Objectives

Nine of the ten customers at issue were high profile athletes. The tenth customer, AT, was a wealthy agent who originally referred most of the athletes to Respondent. The athlete

[2] Tr. 144.

customers had unique financial profiles and planning needs. They received large and varying cash infusions and maintained multi-million dollar accounts. They needed financial planning that took into account their irregular cash flow, their high tax brackets, and the possibility that they would not continue to earn at their current high levels. In addition, the customers' income tax exposure was subject to change when they transferred to a team in a different state. Their agent, AT, was also in a high tax bracket and had complex and variable finances. These customers had demanding travel schedules and were often unavailable during the trading day.[3] Accordingly, they gave Respondent discretionary authority over their accounts.[4]

2. Respondent's Portfolio Management Strategy

Respondent is a highly knowledgeable broker with an MBA in finance and 40 years of study and experience in sophisticated municipal bond portfolio management strategies. Respondent's team of ten representatives serviced at least 500 customer families and 1000 accounts, representing approximately $900 million to $1 billion in assets.[5] Because he managed a large municipal bond portfolio, Respondent gained access to invaluable information from the Firm's institutional trading desk, including a daily trading scale for municipal bonds with various ratings, which allowed him to determine competitive pricing for his customers.[6] His objective was to buy and sell bonds within 50 basis points of the trading scale used by institutional traders.[7]

[3] Tr. 150, 160, 164.

[4] Tr. 304-305.

[5] Tr. 146-147, 300.

[6] Tr. 259, 263-264, 268-269.

[7] Tr. 268, 770-774.

Respondent recommended, and the customers agreed to, a conservative investment strategy involving municipal bond investments, to provide a steady, tax-free return and to grow their assets over time. Consistent with this strategy, the customers' account opening documents indicated an investment objective of capital appreciation.[8] To bolster his customers' financial security, Respondent recommended, and the customers generally agreed, to limit their living expenses to the interest income generated by their municipal bond investments. In that way, his customers would be financially secure when they were unable to continue their athletic careers.

To further reinforce this investment strategy and educate his customers, Respondent met with his customers periodically to review both their investment performance and budgeting. During these meetings, Respondent presented each customer with a binder that included information on account performance and an analysis of the customer's expenditures to determine whether the customer was limiting his expenditures to the interest income generated from the municipal bond investments.[9]

Because his clients held a large inventory of municipal bonds, Respondent sometimes provided liquidity for his customers by cross-trading municipal bonds among customers for their mutual benefit.[10] Prior to engaging in cross-trading, Respondent put each order out for bid to establish a price for the cross trade.[11] After obtaining three bids, he cross-traded the bonds among his customers at the best bid or ask. Unlike an open market transaction, there was no additional markup or markdown to his customers on a cross-trade.[12]

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[8] Tr. 229, 231.

[9] *See, e.g.*, RX-710; Tr. 741, 969, 993-999.

[10] Tr. 147.

[11] Tr. 179-180.

[12] Tr. 298-299.

Respondent employed sophisticated portfolio management strategies based upon his assessment of the market and his customers' unique needs. For example, some customers needed to sell bonds to fund a large capital expenditure such as a house, and others received large cash infusions that needed to be invested.[13] In addition, Respondent, from time to time, took steps to extend or shorten the duration of a portfolio or to improve bond quality based upon Respondent's assessment of the market and the needs of an individual customer.[14] Respondent also made adjustments to portfolios where appropriate to manage risk exposure, such as reducing customers' concentration in California bonds based upon emerging credit quality concerns.[15] He also adjusted portfolios to take advantage of state tax laws when his customers moved to a team in a different state and changed residences.[16]

Respondent testified credibly that the transactions in customer accounts were reasonable and consistent with his customers' needs. This testimony was corroborated by Respondent's contemporaneous notes.[17]

Respondent's transactions were also validated by his highly reputable and credible expert witness, Nathanial Singer. Mr. Singer has 20 years of experience trading municipal bonds, including heading the fixed income department of a major brokerage firm, working with the Financial Accounting Standards Board to write the standards for accounting for municipal bonds and derivatives, teaching engagements at the Securities Industry and Financial Markets Association, and serving on the Board of the financial engineering school at Princeton, his alma

[13] Tr. 452, 545, 621.

[14] Tr. 624.

[15] Tr. 631-633, 1915-1921, 1946-1948, 1951-1952, 1973-1984.

[16] RX-874, at 32-38; Tr. 625, 1987-1988, 2481-2485.

[17] See e.g., RX-231; Tr. 627, 1559-1561.

mater.[18] Mr. Singer reviewed a sampling of the trading activity cited in Schedule A of Enforcement's Amended Complaint and concluded that Respondent had employed an individualized portfolio management strategy for each customer that was best suited for their unique financial situation.[19] Mr. Singer observed:

> [Respondent's] clients were unique in terms of their individual wealth and varying external factors which both directly and indirectly affected both their cash flow and tax planning requirements. [Respondent] could not have and should not have adhered to a simple buy and hold program as their investment advisor. The strategies he employed were designed to enhance returns and at the same time satisfy the cash flow requirements dictated by his clients as well as the tax planning requirements dictated by their accountants. The strategies were consistent with a moderate or conservative risk tolerance, the purchases were focused on high quality credits in order to ensure that principal was not placed at risk, and the focus was not speculative, but designed to capture relative value and enhance income.[20]

One strategy involved the purchase of non-refunded premium bonds in anticipation of their pre-refunding.[21] Respondent's expert witness testified that this is a strategy that is used by sophisticated portfolio managers.[22] Respondent was often able to sell pre-refunded bonds for a profit and replace them with bonds with a longer duration and higher yield.[23] Enforcement's expert witness acknowledged that when a bond is pre-refunded, the value of the bond increases.[24] In some cases, it was beneficial for customers to realize this gain and purchase another bond with a longer duration.

[18] RX-838, RX-839; Tr. 2399-2412.

[19] RX-874, at 1-2; Tr. 2414-2420.

[20] RX-874, at 2.

[21] Pre-refunding occurs when a new bond is issued and the proceeds are used to purchase treasury securities with a call date that matches the original bond. As a result, the duration of the pre-refunded bond is shortened from the maturity date to the call date, and the credit quality is enhanced as a result of the treasury backing. Tr. 2436-2437.

[22] Tr. 2435-2436.

[23] RX-35 at 9-19; Tr. 622, 2008-2012, 2018-2019, 2024, 2027.

[24] Tr. 1668-1669.

In addition, in some instances, Respondent also followed instructions from his customers and their tax advisors to sell bond positions to generate tax losses.[25] Further, when some customers became subject to the alternative minimum tax ("AMT"), they instructed Respondent to sell any bonds that were subject to the AMT, to reduce their tax exposure.[26] These transactions were not solicited and were done in furtherance of the customers' financial goals at the instruction of the customers and their advisors.[27]

3. Respondent's Strategies Were Successful

A review of the customer accounts at issue indicates that Respondent generally outperformed a comparable bond portfolio managed by a leading firm ("the comparable portfolio") at a lower risk to the customer.[28] For example, over a four-year period, customer SA had an annual tax-free return of 2.51% (or 2.71% including tax harvesting) as compared with the 2.35% return of the comparable bond portfolio.[29] Respondent accomplished this performance with a less risky strategy than the comparable portfolio.[30] Similarly, the two customers who testified, NG and JV, achieved tax-free returns of 3.45% and 2.64%, as compared with 2.54%

[25] RX-231, at 6, RX-844; Tr. 455, 2224, 2267-2272.

[26] RX-231; Tr. 627, 2106-2107.

[27] Respondent provided helpful background on the tax selling activity in the customer accounts. He explained that in 2005 and 2006 bond interest rates were moving up and this created an opportunity to generate tax losses by liquidating some existing bonds. Tr. 630, 634, 2332-2333. As a result, Respondent's clients and their financial advisors instructed Respondent to sell losing positions to harvest tax losses and offset capital gains. Tr. 294-295. Tr. 550-570, 632-636, 1971-1973; RX-53-RX-59, RX-843, at 15-16. For example, in 2005 and 2006, customer AT had substantial gains, and, in consultation with his financial advisor, determined to take tax losses against these gains. Pursuant to his customer's request, Respondent reviewed AT's accounts and found bonds that had declined in value, which he showed to AT and his financial advisor. Respondent was then instructed to sell the bonds to realize tax losses. Tr. 300-301, 455. In addition, in 2006, AT became subject to the alternative minimum tax, so he and his financial advisor directed Respondent to sell municipal bonds in his portfolio that were subject to the alternative minimum tax. Tr. 627.

[28] RX-18-RX-27; Tr. 970-972.

[29] RX-18.

[30] Respondent's trading was at a standard deviation of 1.79, as compared with a standard deviation of 2.17 for the comparable portfolio, indicating that Respondent's strategies involved less risk. RX-18; Tr. 967, 2215-2216.

and 2.35% in the comparable portfolio, respectively.[31] Respondent achieved these returns at lower standard deviations of 2.43 (versus 2.71 in the comparable portfolio) and 1.82 (versus 2.17 in the comparable portfolio), respectively.[32]

In summary, the Hearing Panel found that Respondent's trading strategies were crafted to benefit his customers, and consistent with their conservative investment objective of capital appreciation. Moreover, Respondent generally delivered a higher rate of return to his customers with less risk as compared with similar bond fund portfolios.

4. The Customer Accounts Had Low Turnover Rates and Cost-to-Equity Ratios

Turnover rates and cost-to-equity ratios are two common measurements that are used to determine whether trading is excessive. The annual turnover rate for an account is calculated by dividing the total purchases by the account's average equity and annualizing the number.[33] The cost-to-equity ratio measures the percentage of return on a customer's average net equity needed to pay broker-dealer commissions and other expenses. "In other words, the cost-to-equity ratio measures the amount an investment would have to appreciate to break even."[34]

These common measures indicate a low level of trading for the customer accounts at issue. The annual turnover rates ranged from a low of 0.3 to a high of 1, with average annual turnover rates for the two testifying customers, JV and NG, at 0.3 and 0.6, respectively.[35] The

[31] RX-20; RX-26.

[32] *Id.*

[33] *Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814, 821 (9th Cir. 1980); *Jack H. Stein*, Exchange Act Release No. 47335, 2003 SEC LEXIS 338, at *16 (Feb. 10, 2003).

[34] *Rafael Pinchas*, Exchange Act Rel. No. 41816, 1999 SEC LEXIS 1754, at *18 (Sept. 1, 1999).

[35] RX-18-RX-27, at 2; Tr. 979.

cost-to-equity ratios were similarly low, ranging from 0.6 to 1.9. For the two testifying customers, JV and NG, the cost-to-equity ratios were 0.6 to 1.2, respectively.[36]

5. The Daily Trade Volume Was Low

Enforcement's expert testified that he examined all trading in Respondent's 1000 customer accounts, approximately 27,900 trades over a four-year period, which equated to approximately 6,250 trades per year and 30 trades per day. Enforcement's expert acknowledged that this volume of trades was "not terribly large."[37] Particularly when viewed in the context of Respondent's 500 customers, 1000 accounts, and approximately $1 billion under management, the Hearing Panel finds that the average daily number of 30 trades among Respondent's some 1000 customer accounts is low. This low level of trading is not consistent with a claim that Respondent's trading strategy was designed to generate high commission levels.

6. Enforcement Failed to Establish Any Customer Losses

The Amended Complaint alleges that the ten referenced customers lost $1.2 million on the 277 selected trades over a four-year period. The Hearing Panel finds that Enforcement's loss calculation was not reliable for several reasons.

First, rather than amortizing premium bonds as required by the Internal Revenue Service and as reflected in customer account statements, Enforcement's expert applied a simple, and incorrect, calculation - he subtracted each premium bond's unamortized sale price from its

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[36] *Id.*

[37] Tr. 1695-1696.

purchase price, and also subtracted transactions costs.[38]

Second, Enforcement's expert failed to consider the interest paid on the bonds. However, a calculation of a bond's total return must include interest income received on the bond.[39]

Specifically, the FINRA website information on "Bond Basics – Figuring Return" states:

> To figure total return, start with the value of the bond at maturity (or when you sold it) and add all of your coupon earnings and compounded interest. Subtract from this figure any taxes and any fees or commissions. Then subtract from this amount your original investment amount. This will give you the total amount of your total gain or loss on your bond investment.[40]

Finally, Enforcement's loss calculation incorrectly included tax loss sales; that is, sales requested by the customers and their financial advisors for the purpose of generating losses. These transactions cannot be considered in an excessive trading analysis because Respondent did not control the trading.[41]

The Hearing Panel finds that each of these errors causes Enforcement's loss calculations to be inaccurate and unreliable.

7. Summary of Findings of Fact Regarding the Trading Activity

As discussed above, the Hearing Panel finds that Respondent's sophisticated portfolio management strategies were consistent with the customers' unique financial profiles and investment objectives and these strategies generally outperformed the market. Moreover, the ten

[38] For tax purposes, the Internal Revenue Service requires bond premiums to be amortized. IRS Publication 550, p. 35 (2012). Brokerage account statements automatically make this calculation. Tr. 951. Thus, for example, the basis of a 10-year bond purchased at 10 basis points over par (110) is reduced one basis point each year until the basis returns to par (100) at the bond's maturity date. Thus, if the 10 year bond purchased at 110 were sold in year five at 106, Enforcement's calculation would show a loss, when in fact there is a gain. *See* RX-864, pp. 40-41; Tr. 943-956.

[39] *See* OHO Redacted Decision 2005000171202 (Sept. 20, 2010).

[40] RX-900. *See e.g.*, Tr. 961-963.

[41] *See* discussion, infra.

customers' turnover rates and cost-to-equity ratios were low, and, consistent with this, the overall volume of trading across Respondent's customer base was low. In addition, the evidence offered at the hearing did not support the allegation of losses to the customer accounts.

C. Enforcement Failed to Establish that Respondent Misrepresented the Commissions He Would Charge

The Amended Complaint alleges that Respondent orally misrepresented to five customers that commission charges would not exceed 0.5% of the par value of the bond, or $5 per $1,000 bond. Enforcement offered the testimony of one customer, NG, and documentary evidence relating to another customer, AT, to support this claim.[42] As discussed below, the Hearing Panel finds that the evidence offered at the hearing was insufficient to establish that Respondent misrepresented the commissions he would charge.

Specifically, NG testified that 17 years ago in 1995, his agent AT told him that Respondent charged 0.5% commission on bond transactions and that Respondent confirmed this arrangement with NG.[43] NG was just starting his baseball career at the time of the meeting, and his recollection was vague; he could not recall the year or location of the meeting, and he did not recall whether or not his father was with him.[44] NG never complained about the commission level during the many years he was with Respondent, even though he asked for and received a separate commission ledger.[45] The Hearing Panel finds that NG's testimony was not reliable due to his poor recollection of the alleged representation.

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[42] Enforcement also offered the testimony of Respondent's former colleague RJ. However, the Hearing Panel did not find RJ's testimony probative, because he did not recall whether he and Respondent met with any of the customers referenced in the Complaint. Tr. 534, 537.

[43] Tr. 71-72.

[44] Tr. 106, 579.

[45] Tr. 74-75, 112-113, 126, 131-132.

Enforcement also presented a November 2006 email from Respondent's customer, AT, asserting that Respondent agreed to charge 0.5% per bond.[46] The Hearing Panel finds that this email is unreliable hearsay.[47] In reaching this determination, the Hearing Panel considered that, in determining whether to rely on hearsay evidence, it is necessary to evaluate its probative value and reliability, and the fairness of its use.[48] The factors to consider include: (1) the possible bias of the declarant; (2) the type of hearsay at issue, whether the statements are signed and sworn to rather than anonymous, oral or unsworn; (3) whether the statements are contradicted by direct testimony; (4) whether the declarant was available to testify; and (5) whether the hearsay is corroborated.[49]

AT, the customer who initially complained that Respondent misrepresented the commissions to be charged, did not testify at the hearing, despite adjustments to the hearing schedule to accommodate his changing schedule. In declining to credit AT's email regarding an oral agreement on the fees, the Hearing Panel considered that AT had commissioned an audit of his accounts with Respondent in 2004 suggesting that the sales commission charge was approximately 2%, but AT failed to take issue with the charges.[50] The Hearing Panel also considered it unlikely that Respondent would misrepresent the commission to AT, a sophisticated investor with multiple advisors reviewing the account activity. Additionally, absence of a writing memorializing the commission rate was inconsistent with the fact that AT

[46] CX-37A at 6.

[47] *Dep't. of Enforcement v. Sears*, No. C07050042, 2007 NASD Discip. LEXIS 26, at *14 (NAC Sept. 24, 2007), *aff'd in part, Wanda P. Sears*, Exchange Act Rel. No. 58075, 2008 SEC LEXIS 1521 (July 1, 2008).

[48] *See Charles D. Tom*, Exchange Act Rel. No. 31081, 1992 SEC LEXIS 2000, at *7 (Aug. 24, 1992).

[49] *Id.*

[50] RX-595, p.3

was a sophisticated investor with multiple advisors. AT's assertion was also uncorroborated. Thus, the email fails to satisfy the criteria for reliable hearsay evidence.

For these reasons, the Panel finds that Enforcement did not meet its burden of proof with respect to the misrepresentation charge.

D. Respondent Exercised Discretion in Customer Accounts to Purchase and Sell Bonds After the Firm Prohibited Discretionary Trading

The fifth cause of the Amended Complaint charges that Respondent exercised discretion in nine customer accounts at a time when such discretion was prohibited by his Firm. As discussed below, the Panel found that the evidence offered at hearing supports this charge with respect to the accounts of JV and his wife, but not the remaining customer accounts.

1. The Firm Changes its Discretionary Trading Policies and Subsequently Investigates Trading in Respondent's Accounts

When Respondent joined the Firm in 2002, he requested and obtained from his customers a written grant of discretion to trade their accounts.[51] At that time, the Firm permitted discretionary trading in customer accounts. However, on January 31, 2006, the Firm changed its policy and no longer permitted the exercise of discretion in non-advisory accounts.[52] As a result of this change in policy, Respondent was required to either contact each customer before executing each trade or change each account to an advisory account.[53] Respondent was aware of the Firm's change in policy and received training on it, and he testified that he or his staff

[51] Tr. 160.

[52] CX-14, CX-26A; Tr. 170, 360-361, 1129.

[53] If Respondent converted his accounts to advisory accounts he would be required to place orders through the trading desk. He would also be unable to engage in cross-trading, and his customers would be subject to markups imposed by the trading desk. Tr. 981-985.

complied with the new policy by contacting each customer before placing a trade in the customer's account.[54]

In March 2006, the Firm did a special review of activities in accounts where the broker previously had exercised discretion.[55] As part of this review, the Firm looked at trading in Respondent's client accounts and found 15 instances of trading requiring further follow up.[56] FINRA Staff conducted a broader investigation of this activity for the period from January 31, 2006, through August 31, 2006.[57] FINRA Staff used the Firm's records to attempt to match customer telephone numbers with telephone numbers for Respondent's office.[58] Where FINRA Staff was unable to match telephone records with trades, it concluded that Respondent had not spoken with the customers to obtain their approval in advance of the trades.[59]

2. Enforcement's Reliance on Telephone Records as Evidence of Customer Contacts

The Hearing Panel finds that the telephone records do not offer a reliable picture of communications between customers and Respondent and his staff for a number of reasons. First, the analysis only captured the customer telephone numbers contained in account opening documents, so telephone numbers omitted from these forms, such as cellular phone numbers, were not part of FINRA Staff's review.[60] Second, approximately 60% of the records identified the outside telephone lines as "unknown," likely due to the fact that these outside telephone lines

[54] Tr. 618, 620-621.

[55] Tr. 359-360, 368.

[56] CX-79, CX-79A; Tr. 371-372, 382, 1120.

[57] Tr. 1184-1185.

[58] Tr. 398.

[59] CX-61; Tr. 1260.

[60] Tr. 413-414.

blocked caller identification.[61] Third, the Firm's telephone records are incomplete. For example, on February 16, 2006 (a Thursday), the Firm's records show only 17 inbound and outbound calls for Respondent's office. Given that Respondent's office included ten licensed individuals servicing at least 500 customer families and 1,000 accounts, it is unlikely that there were so few calls on that day.[62] Fourth, the analysis did not include the cellular telephone records of Respondent's team.[63] Finally, the analysis did not take into account the possibility that Respondent or his team reached a customer at a hotel or other telephone number other than the telephone number in the Firm's records, a point of particular relevance here because these customers traveled frequently.[64] Due to the lack of reliability of the telephone records to evidence all communications between Respondent and his staff and the customers, the Hearing Panel finds that these records alone are insufficient to meet Enforcement's burden of proof with respect to the charges in causes five and six.

However, Enforcement called three customers to testify in support of cause five: JV, JV's wife, and LM. The Hearing Panel considered this additional evidence and concludes that Enforcement established a violation of Firm policy with respect to the accounts of JV and his wife, but did not establish a violation with respect to the account of customer LM.

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[61] CX-36A; Tr. 416-417, 1361-1362.

[62] CX-36A at 22; Tr. 146-147, 620, 1363-1369.

[63] Tr. 415.

[64] Tr. 431-432.

3. The Accounts of JV and His Wife

In January 2002, JV and his wife opened a joint account with Respondent.[65] In addition, during a period when they were separated in the spring of 2006, JV and his wife each opened a separate account.[66]

Respondent executed trades in these three accounts after the Firm prohibited discretionary trading on January 31, 2006. Specifically, for the period ending in August of 2006, Respondent made 16 trades in JV's joint account with his wife, six trades in JV's separate account, and five trades in the separate account of JV's wife.[67] It is undisputed that under the Firm's new policy, Respondent was required to obtain his customers' permission before executing each of these trades. JV and his wife testified that Respondent did not obtain this required permission.

JV was a successful professional baseball player from Latin America who did not speak English.[68] JV testified through an interpreter that he and his wife met with Respondent once or twice a year.[69] Because JV could not speak English and Respondent could not speak Spanish, any communications JV received from Respondent were transmitted by JV's wife, who translated them from English to Spanish.[70] Beyond these meetings, JV had no contact with

[65] CX-10 at 13; Tr. 665. As of December 2002, the account was worth over $5 million. RX-709; Tr. 682-683.

[66] CX-61C, CX-10 at 27-41; Tr. 669, 695, 719.

[67] CX-61A, CX-61B, CX-61C; Tr. 720-721.

[68] Tr. 659-660, 662, 670-671.

[69] Tr. 664.

[70] Tr. 664, 680.

Respondent or Respondent's staff.[71] Thus, JV did not give permission prior to the execution of particular trades in either the joint account with his wife, or his separate account.[72]

The testimony of JV's wife was consistent with JV's testimony. Although she had general discussions with Respondent as to the accounts, Respondent never asked for or obtained her permission to make a specific trade either before or after January 31, 2006.[73]

While Respondent claims that he obtained required approvals from his customers as to each of the trades in their account after January 31, 2006, he did not recall specific conversations and did not offer contemporaneous notes of these conversations. In addition, he offered no explanation as to how he could have obtained JV's approval for the six transactions in JV's separate account given that Respondent could not speak Spanish and JV could not understand English.[74]

Based upon the record evidence, the Hearing Panel finds that Respondent exercised discretion in municipal bond transactions in the separate accounts of JV and his wife as well as in their joint account.

4. Customer LM's Account

Customer LM opened an account with Respondent at the Firm in January 2002.[75] At that time, LM gave Respondent discretion to trade the account. Over the period at issue, the account had approximately six positions and there was minimal trading activity.[76]

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[71] Tr. 665.

[72] Tr. 660, 665.

[73] CX-61B; Tr. 696-697, 721-722.

[74] Tr. 668-670, 1009; CX-61A.

[75] Tr. 880-881.

[76] *Id.*

LM testified that he spoke with Respondent about his account four or five times a year, and sometimes spoke with Respondent's assistants.[77] He generally followed Respondent's recommendations.[78] He received monthly statements, which he sometimes reviewed with "a fine tooth comb."[79]

As noted above, beginning on January 30, 2006, the Firm no longer permitted Respondent to exercise discretion in customer accounts. The Complaint charges that Respondent's March 30, 2006, purchase of 60 pre-refunded Biloxi Mississippi bonds for LM's account was in contravention of this new restriction.[80] Enforcement called LM to testify in support of its claim.

LM testified that he could not recall whether Respondent obtained his permission prior to making the purchase.[81] He also did not recall a conversation with Respondent as to the sale of stock to fund the purchase of the Biloxi bond.[82] However, LM testified that he generally purchased municipal bonds in increments of 25, so he did not believe that he would have authorized a 60-bond purchase.[83] He testified that this Biloxi bond purchase was the only transaction in his account over a four-year period that he challenged as not authorized.[84]

In contrast, Respondent provided specific testimony about his conversations with LM during which LM authorized the purchase of the bond. He explained that LM liquidated two

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[77] Tr. 887, 890.

[78] Tr. 886.

[79] Tr. 887.

[80] Tr. 887.

[81] Tr. 891, 913-914.

[82] Tr. 909-910.

[83] Tr. 912.

[84] Tr. 921.

securities positions totaling $65,000 in anticipation of the purchase of a house.[85] LM confirmed that he authorized the sale of these securities.[86] Respondent explained that, in connection with the liquidation of these securities, he and LM discussed purchasing a pre-refunded bond to treat as a cash equivalent which could be held until funds were needed to purchase the house.[87] After Respondent identified the Biloxi bond, he called LM and obtained his authority for the purchase.[88]

The Hearing Panel finds that Respondent's testimony, corroborated by account records, and partially corroborated by LM's testimony, is credible. Therefore, the Hearing Panel finds that Enforcement failed to prove, by a preponderance of the evidence, that Respondent exercised discretion in LM's account when he purchased the Biloxi bonds.

[85] Tr. 2048.

[86] Tr. 909-911.

[87] Tr. 2048-2049.

[88] Tr. 2048-2049.

E. Enforcement Failed to Prove that Respondent Exercised Discretion in a Customer Account to Purchase Equity After the Firm Prohibited Discretionary Trading

The sixth cause of the Amended Complaint charges that Respondent exercised discretion in a customer account to purchase equity at a time when such discretion was prohibited by UBS. However, the customer at issue did not testify. As discussed above, the Hearing Panel found that the telephone records alone are insufficient to meet Enforcement's burden of proof with respect to Respondent's exercise of discretion. Therefore, Enforcement failed to meet its burden of proof with respect to this cause.

III. CONCLUSIONS OF LAW[89]

A. Respondent Exercised Discretion in a Customer Account After the Firm Prohibited Discretionary Trading, in Violation of MSRB Rule G-19(d).

The fifth cause of the Amended Complaint alleges that Respondent exercised discretion without approval from his Firm in 539 municipal bond transactions in nine customer accounts. The Amended Complaint alleges that Respondent acted on the customers' written grant of discretion after the Firm had changed its policy to prohibit the use of such discretion.[90] Specifically, the Amended Complaint charges that Respondent violated MSRB Rule G-19(d), which prohibits a broker from exercising discretion in a customer account unless he or she has written authorization from the customer and approval by the firm.

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[89] 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 in some cases the prior rules were re-numbered and/or revised. *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 and rules that were in effect at the time of the Respondent's alleged misconduct and cited in the Amended Complaint.

[90] The Amended Complaint charges that Respondent's misconduct was willful. However, because this is not an element necessary to establish a violation, the Hearing Panel did not reach the issue in connection with its determination as to the violative misconduct.

Here, there is no dispute that in January 2006, the Firm changed its policy and prohibited all discretionary trading in customer accounts, regardless of whether the customers authorized it. As noted above, the Hearing Panel finds that Respondent continued to exercise discretion in the separate accounts of JV and his wife as well as in their joint account, after the Firm's policy prohibited the exercise of such discretion. Accordingly, the Hearing Panel finds that Respondent violated MSRB Rule G-19(d).

B. Enforcement Failed to Prove that Respondent Exercised Discretion in a Customer Account to Purchase an Equity After the Firm Prohibited Discretionary Trading

The sixth cause of the Amended Complaint alleges that Respondent exercised discretion on an equity transaction without prior written approval by his Firm. However, as noted above, Enforcement failed to meet its burden of proof on this charge. Accordingly, the Hearing Panel dismisses this charge.

C. Enforcement Failed to Prove that Respondent Engaged in Excessive Trading and Churning

The first, second, and third causes of the Amended Complaint charge that Respondent engaged in excessive trading in ten customer accounts from January 2002 until September 2006, in violation of MSRB Rule G-19(c), which provides that "[i]n recommending to a customer any municipal security transaction, a broker…shall have reasonable grounds (i) based upon information available from the issuer of the security or otherwise, and (ii) based upon the facts disclosed by such customer or otherwise known about such customer for believing that the recommendation is suitable."[91] This Rule is the counterpart to former NASD Rule 2310(a), which was the NASD's suitability rule at the time of the alleged violations. The Amended

[91] These customer names are abbreviated as NG, JW, MK, SV, AT, JV, TO, BB, ML, and SA. Only NG, JV, and JV's wife testified regarding these charges.

Complaint also alleges that Respondent violated MSRB Rule G-19(e) by engaging in fraudulent excessive trading (commonly referred to as "churning") and, derivatively, MSRB Rule G-17, because this excessive trading constituted a failure to deal fairly with his customers.

As discussed below, Enforcement failed to meet its burden of proof that the low level of trading in the customer accounts was quantitatively excessive.

Quantitative suitability centers on whether the "number of transactions" [92] or the "level of trading"[93] within a given timeframe is suitable in light of the customer's financial circumstances and investment objectives.[94] Here, Enforcement and its expert reviewed 27,900 transactions in Respondent's customer accounts and selected 277 transactions over a four-year period among ten customer accounts, an approach contrary to the analysis traditionally applied, which views the activity in the account as a whole.[95]

Specifically, although no single test determines what constitutes excessive activity, cases considering the issue uniformly look to the turnover rate and cost-to-equity ratio, and whether there is extensive use of "in and out" trading.[96] An annualized turnover rate greater than six is

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[92] *Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *32 (NAC July 30, 2009).

[93] *Gerald E. Donnelly*, 52 SEC 600, 603 (1996).

[94] A finding of quantitative unsuitability also "requires a showing of: (1) 'broker control over the account in question'; and (2) 'excessive trading activity inconsistent with the customer's financial circumstances and investment objectives.'" *Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *33 (NAC May 10, 2010) (quoting *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34). In addition, it requires proof that the respondent "recommended" the trades at issue. *Dep't of Enforcement v. Murphy*, No. 2005003610701, 2011 FINRA Discip. LEXIS 42, at *43 n.33 (NAC Oct. 20, 2011) (citations omitted). However, the Hearing Panel did not reach these issues because it found that the trading was not excessive.

[95] *See Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, *aff'd*¸ *Richard G. Cody*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011); 2012 U.S. App. LEXIS 18914 (1st Cir. Sept. 7, 2012); *Rafael Pinchas*, Exchange Act Rel. No. 41816, 1999 SEC LEXIS 1754 (Sept. 1, 1999); Tr. 1488.

[96] *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34-35.

generally considered to evidence excessive trading. [97] A cost-to-equity ratio above 20 percent generally indicates excessive trading.[98] In some instances, excessive trading has been found with numbers below these widely established levels. In *Department of Enforcement v. Cody,* a case that, like this one, involved bond trading, the National Adjudicatory Council found excessive trading with a turnover rate as low as 3.4 and a cost-to-equity ratio of 8.7, "figures lower than what are usually held to be conclusive or presumptive evidence of excessive trading" where the customers were elderly and had limited financial resources.[99]

Enforcement did not apply these standard measures of excessive trading to the facts of this case. However, since these measures are uniformly applied in cases involving allegations of excessive trading, the Hearing Panel found them to be instructive. Here, even when the unsolicited tax trades are included in some of the customer accounts, the turnover rates ranged from a low of 0.3 to a high of 1, with average turnover rates for the two testifying customers, JV and NG, of 0.3 and 0.6, respectively.[100] The cost-to-equity ratios were similarly low. For the two testifying customers, JV and NG, the cost-to-equity ratios were 0.6 to 1.2, respectively.[101] These levels are far below the levels that generally indicate excessive trading. In fact, they are well below the levels that have been held to be indicative of excessive trading, even where other factors are present.

[97] *Jack H. Stein,* Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *118 (Feb. 10, 2003).

[98] *See, e.g., Rafael Pinchas*, Exchange Act Rel. No. 41816, 1999 SEC LEXIS 1754, at *18 (explaining that "[w]e have previously found that a cost-to-equity ratio in excess of 20% indicates excessive trading").

[99] 2010 FINRA Discip. LEXIS 8, at *40.

[100] RX-18-RX-27.

[101] RX-20, p.2; RX-26, p. 2.

Moreover, Respondent's customers and their financial advisors instructed Respondent to sell positions to recognize tax losses.[102] Because these transactions were not solicited and Respondent therefore did not exercise control, they cannot be considered in the calculation of the quantitative measures used in determining whether trading is excessive.

Enforcement's argument also is not supported by the evidence because Enforcement failed to consider whether the replacement bonds resulted in an improvement to the customers' investment portfolio. In fact, Respondent presented evidence at the hearing both with respect to individual transactions and the accounts' performance as a whole which indicated that the customers generally benefitted from his strategies.

In addition, Respondent testified extensively and credibly as to the rationale for his trading strategy as consistent with his customers' overall needs. This testimony was supported by credible expert testimony and corroborated by Respondent's contemporaneous notes.[103]

Based on the foregoing, the Hearing Panel finds that Enforcement failed to meet its burden to establish that the trading was excessive, and the charges of churning and unfair dealing also fail. Accordingly, the Hearing Panel dismisses the first, second, and third causes of action.

D. Enforcement Failed to Prove that Respondent Misrepresented the Commissions He Would Charge

Cause four of the Amended Complaint alleges that Respondent orally misrepresented to five of the ten customers that commission charges would not exceed 0.5% of the par value of the bond, or $5 per $1,000 bond. As noted above, the Hearing Panel finds that Enforcement failed to meet its burden to establish that such misrepresentations were made. Accordingly, the Hearing Panel dismisses this charge.

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[102] Tr. 2267-2272.

[103] Tr. 1559-1561.

IV. SANCTIONS

The Hearing Panel was charged with determining the appropriate sanction for Respondent's exercise of discretion with respect to the 27 trades in the accounts of JV and his wife after UBS prohibited discretionary trading in violation of MSRB Rule G-19(d). The FINRA Sanction Guidelines ("Guidelines") for MSRB Rule G-19(d) violations recommend a fine of between $2,500 and $10,000 and, in egregious cases, a suspension in any or all capacities for 10 to 30 business days.[104] Principal considerations include whether the customer's grant of discretion was express or implied and whether the firm's policies and/or procedures prohibited discretionary trading and/or whether the firm prohibited the respondent from exercising discretion in customer accounts.[105] In determining the appropriate sanction, the Hearing Panel considered that the violation was limited to 27 transactions in the accounts of JV and his wife. Respondent had express written authorization from these customers, but, after January 31, 2006, the Firm revoked its approval of this authorization and Respondent was no longer permitted to exercise discretion as he had in the past. Although Respondent was aware of the change in Firm policy, he violated it by executing trades in the accounts of JV and his wife without obtaining the Firm's prior approval for these specific trades.

Because the violation of Firm policy involved a small number of trades and only one family which had previously granted written discretion to Respondent, the Hearing Panel does not find the misconduct egregious. Therefore, a suspension is not warranted. The Hearing Panel concludes that a $5,000 fine is the appropriate sanction for this violation.

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[104] Guidelines at 85.

[105] *Id.*

V. CONCLUSION

The Hearing Panel finds that Respondent exercised discretion in customer accounts after his firm prohibited discretionary trading, in violation of MSRB Rule G-19(d). For this violation, Respondent is fined $5,000.[106] Respondent is also ordered to pay costs of the hearing in the amount of $2,258.63, which includes a $750 administrative fee and a portion of the cost of the hearing transcripts. 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. The Hearing Panel dismisses the remainder of the charges in the Amended Complaint because Enforcement failed to prove by a preponderance of the evidence that Respondent engaged in excessive trading and churning, in violation of MSRB Rules G-17, G-19(c) and G19(e); made material misrepresentations to customers, in violation of MSRB Rule G-17; and exercised discretion with respect to an equity transaction, in violation of NASD Rules 2510(b) and 2110.[107]

Sara Nelson Bloom
Hearing Officer
For the Extended Hearing Panel

[106] Securities and Exchange Act Section 15B(c)(9) provides that fines for violation of MSRB Rules collected by FINRA shall be allocated 2/3 to FINRA and 1/3 to the MSRB. Accordingly, the $5,000 fine shall be allocated $3,333 to FINRA and $1,667 to the MSRB.

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