

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent.

Disciplinary Proceeding
No. 2007009461301

Hearing Officer – MC

**EXTENDED HEARING PANEL
DECISION**

October 8, 2010

The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent: (i) made unsuitable recommendations to customers to engage in covered call options transactions, in violation of Conduct Rules 2110, 2310, and 2860(b)(19); (ii) failed to explain adequately the risks of engaging in a covered call options strategy, in violation of Conduct Rule 2110; and (iii) made false and misleading communications to two customers, in violation of Conduct Rules 2110, 2210(d)(1) and 2220(d)(1). Accordingly, Respondent is found not liable for the violations alleged in the Complaint, and the Complaint is dismissed.

Appearances

Gino F. Ercolino, Senior Counsel, Ronald W. Sannicandro, Senior Counsel, and Martin S. Mazur, Director, New York, NY, for the Department of Enforcement.

Julian W. Friedman, Esq., and Carolyn Barth Renzin, Esq., Stillman, Friedman & Shechtman, P.C., New York, NY, for Respondent.

DECISION

I. Background¹

The central issue in this case is whether Respondent made unsuitable recommendations to seven customers from 2002 to 2004, when he was a financial advisor for FINRA member firm Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill”).²

¹ References to the testimony at the hearing are designated as “Tr. ___.” References to Enforcement’s Exhibits are designated as “CX-___.” References to Respondent’s Exhibits are designated as “RX-___.”

At Merrill, Respondent's clientele consisted of approximately 45 customers who were active or retired employees of United Parcel Service, Inc., or their relatives.³ When they became Respondent's clients, the seven customers involved in this case, described in the Complaint as the "complaining customers," held sizable, concentrated positions in UPS stock acquired over years of employment with the company. In the period covered by the Complaint, from 2002 to 2004, most of Respondent's clientele, and all of the complaining customers, engaged in covered call writing with UPS stock.⁴

It is undisputed that the complaining customers shared in a "UPS culture," valuing retention of ownership of their UPS stock. Nonetheless, they all informed Respondent that they

² Respondent first joined Merrill in May 2000. CX-1, p. 4, sub-page 13. While receiving Merrill's training for financial advisors, Respondent obtained several licenses including: Series 7; Series 31; Series 66; and an insurance license. CX-1, p. 4, sub-page 10; CX-2a, p. 1. He became a financial advisor and was registered in October 2000. Tr. 875-76. Respondent remained at Merrill until January 2008, when he became employed as a financial advisor with another FINRA member firm. Tr. 761-62. FINRA has jurisdiction over this disciplinary proceeding because the alleged misconduct occurred while Respondent was registered with FINRA through Merrill, and because he continues to be registered with FINRA.

³ Tr. 768.

⁴ Tr. 768-69. At the hearing, the expert witnesses for both parties described covered call writing as a trading strategy generally considered to be conservative in nature. *See* the testimony of Enforcement's expert, Marc Allaire, at Tr. 1182-83, and the testimony of Respondent's expert, James French, at 1529-1530, 1558. To engage in this strategy, an investor who owns stock is said to "write," sell or grant a call option. By so doing, the owner of the stock agrees to sell the shares at a set price, known as the strike price, or the exercise price, until the obligation expires, on what is known as the options expiration date. Tr. 1181. To compensate the owner for assuming this temporary obligation, the purchaser of the call pays a premium. The premium remunerates the writer for giving up the potential profit he might earn if the market price of the stock increases past the strike price. Tr. 1182. The call buyer then has the right at any time until the expiration date to purchase the shares at the strike price. If the market price of the stock rises higher than the strike price, the buyer is likely to "exercise the call," or "call away" the shares and purchase the stock at the strike price. If the market price of the stock stays stable or drops below the strike price, the buyer of the covered call is unlikely to exercise the call, because he would have to pay a price higher than the market price. If the call is exercised, or assigned, the owner of the underlying stock shares retains the premium and the difference, if any, between the price at which the owner originally acquired the stock and the strike price. If the purchaser of the call does not exercise the right to purchase the stock, the owner keeps the stock and the premium received. If the price of the stock rises and the owner of a call option does not wish to sell the stock at the strike price, the owner may buy back the call, terminating the obligation to sell it. Of course, the owner may have to pay more to repurchase the call than the price for which he sold it. The owner may elect to gain time by buying the call back and then selling it with a later expiration date. For example, the owner may have sold a call at \$55 with a March expiration date. As the expiration date approaches, the owner can repurchase the March call, and sell an April call. This is known as "rolling out" if the owner sells the call at the same strike price. Rolling out at a higher strike price is known as "rolling up" or "rolling up and out;" rolling out at a lower strike price is known as "rolling down." A strike price at or below the market price of the stock is said to be "in the money" or, if significantly below the market price, "deep in the money." If the strike price is above the market price, it is said to be "out of the money." Tr. 1200-1201.

wished to use UPS shares to write covered calls to generate cash to supplement their UPS dividend incomes.

When they started, the complaining customers earned substantial premiums from their covered call writing. Through 2002 and much of 2003, the share price of UPS common stock was fairly stable.⁵ During this period, the complaining customers wrote covered calls with strike prices above the market price and the calls frequently expired. For the complaining customers, this was the ideal situation: they retained their UPS stock, which was appreciating in value; they continued to collect UPS dividends; and they enjoyed the cash flow generated by the premiums.

However, in 2003, the price of UPS fluctuated and then rose quickly. As one witness explained, a significant and quick UPS price increase from October to December 2003,⁶ moving the market price above the customers' strike prices, was disadvantageous to the complaining customers, reducing their premiums and making exercise of the calls virtually certain.⁷ They had to decide whether to let the shares go, or to repurchase the calls and roll them forward. For a time, they rolled the calls forward in the money. They were unhappy with the costs they incurred, and dissatisfied with their "opportunity loss," unable to profit from the rising market price of the shares as they would have if they had written covered calls. Their dissatisfaction caused them to become the complaining customers in this case.

⁵ The closing share price of UPS stock in 2002 rose, with some fluctuations, from approximately \$55 to \$66.85. RX-70, pp. 15-20.

⁶ Tr. 2056. The closing price of UPS shares rose from \$64.35 on October 1, 2003, to more than \$74 by the end of December 2003. RX-70, pp. 11-12.

⁷ Tr. 2047-49.

II. Complaint

On May 18, 2009, the Department of Enforcement filed the three-cause Complaint in this disciplinary proceeding.⁸ In a nutshell, Enforcement argues that recommending covered calls to the complaining customers, “while knowing that these customers were so adamantly unwilling to part with their UPS stock, was inherently inappropriate and violative of NASD Rules 2310 and 2860(b)(10).”⁹ Specifically, the First Cause of Action alleges that Respondent violated Rules 2110, 2310, and 2860(b)(19) when he recommended covered call options without a reasonable basis for believing (i) that the recommendations were suitable, or (ii) that the complaining customers had the ability to evaluate the risks. The Complaint alleges that Respondent, despite knowing the complaining customers were unwilling to sell their shares of UPS stock, nonetheless repeatedly recommended writing covered calls at strike prices below the market price (“in the money” and “deep in the money”) at a time when the market price of UPS stock was rising, thus making exercise of the calls almost certain. The Complaint describes the complaining customers as unsophisticated investors without any experience in covered call writing who were unaware of and lacked the ability to evaluate the risks, and thus depended entirely on Respondent’s recommendations. Finally, the First Cause of Action alleges that Respondent’s unsuitable recommendations caused the complaining customers to incur losses exceeding \$4 million in total.

The Second Cause of Action alleges that Respondent violated Rule 2110 because he failed to explain the risks inherent in writing covered calls.

⁸ On November 25, 2009, Enforcement filed a motion for leave to file an Amended Complaint, with Respondent’s consent, which was granted on December 8, 2009. The Amended Complaint is identical to the original Complaint, except the Third Cause of Action alleges that Respondent sent a false and misleading communication to a second customer not included in the original Complaint. The Decision refers to the Amended Complaint as the Complaint.”

⁹ Enforcement’s Post-Hearing Brief, p. 17 (May 5, 2010).

Finally, the Third Cause of Action alleges that Respondent violated Rules 2110, 2210(d)(1), and 2220(d)(1) by creating and sending account summaries to two customers that were false, exaggerated, unwarranted, or misleading. The Complaint alleges that the summaries misled the customers into believing that they were making more money from covered calls than they were.

Respondent's Answer denies the allegations and contends that he acted at all times in what he reasonably believed to be the best interests of his customers. Because their investments were concentrated in UPS stock, he repeatedly recommended that the complaining customers diversify their holdings. Respondent claims that covered call writing was, for them, a step towards diversification.

An Extended Hearing Panel consisting of a current member of the District 10 Committee, a current member of the District 11 Committee, and the Hearing Officer, convened the eight-day hearing in this matter on March 1, 2010, in New York, NY.

III. First Cause of Action: Suitability

A. Legal Standard and Burden of Proof

Conduct Rule 2310 requires a registered representative to possess a reasonable belief that recommended transactions are suitable for a customer, based upon information obtained from the customer and reasonable inquiry into the customer's investment objectives, financial situation, and needs.¹⁰ To meet the standards of suitability required by Rule 2310, recommendations must

¹⁰ *Rafael Pinchas*, Exch. Act Rel. No. 41816, 1999 SEC LEXIS 1754, at *19-20 (Sept. 1, 1999).

also be consistent with the customer's best interests¹¹ and consonant with the fundamental responsibility for fair dealing to which representatives must adhere.¹²

FINRA's rules impose an even stricter suitability standard for recommending options transactions.¹³ Conduct Rule 2860(b)(19) creates a two-pronged responsibility. The first prong is essentially indistinguishable from the obligations imposed by Rule 2310. The second prong requires the representative recommending an options transaction to have a "reasonable basis for believing ... that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks ... and 'to bear the risks.'"

To prevail in Cause One, Enforcement must prove by a preponderance of the evidence that: (i) Respondent recommended unsuitable options transactions without reasonable grounds to believe the transactions were suitable, given the financial situations, needs, and investment objectives of customers; and (ii) Respondent lacked a reasonable basis to believe his customers possessed sufficient knowledge and experience to be reasonably deemed capable of evaluating and bearing the risks.

Enforcement presented no evidence that the financial situations of the complaining customers rendered the covered call transactions at issue unsuitable. Rather, the thrust of Enforcement's case in the First Cause of Action is that Respondent recommended the strategy of covered call writing in contravention of the customers' claimed objective of retaining ownership

¹¹ *Scott Epstein*, Exch. Act. Rel. No. 59328, 2009 SEC LEXIS 217, at *40, n. 24 (Jan. 30, 2009) (citing *Raghavan Sathianathan*, Exch. Act. Rel. No. 54722, 2006 SEC LEXIS 572 (Nov. 8, 2006); *Dep't of Enforcement v. Dunbar*, No. C07050050, 2008 FINRA Discip. LEXIS 18 (NAC May 20, 2008).

¹² *Scott Epstein*, *supra*, at *38-39.

¹³ *Arthur Joseph Lewis*, Exch. Act. Rel. No. 29794, 1991 SEC LEXIS 2245 at *4 (Oct. 8, 1991).

of their UPS stock, without a reasonable basis for believing they understood the risks of losing it.¹⁴

B. Credibility

The complaining customers who testified at the hearing gave similar accounts of their experiences writing covered calls with Respondent. They all claimed that: (i) they did not wish to sell their UPS stock; (ii) they did not comprehend the risks of covered call writing because Respondent assured them that there were none; and (iii) they did not understand how covered call writing worked.

To sustain the allegations in the Complaint, the Extended Hearing Panel would be required to credit the complaining customers' testimony over Respondent's. For the reasons set forth in this Decision, the Extended Hearing Panel declines to do so. The complaining customers' testimony was in many instances contradicted, while Respondent's was corroborated, by documents, including e-mail messages and notes of conversations with customers (known as "ACT" notes)¹⁵, created close in time or contemporaneously with those conversations. No evidence undermined the accuracy of the ACT notes or showed them to be contrived or unreliable.

C. Respondent Reasonably Concluded the Complaining Customers Were Not Unalterably Opposed to Diversifying

Respondent testified that he advised all of his customers to diversify because their concentration in UPS stock was risky, particularly for retirees.¹⁶ Some customers heeded his

¹⁴ Enforcement's Post-Hearing Brief, pp. 15-17.

¹⁵ Tr. 794-96.

¹⁶ Tr. 816-17; 1600-01.

advice immediately;¹⁷ for others, Respondent testified, it was a slow process to change long-held attitudes about retaining ownership of UPS stock.¹⁸ Respondent conceded that the complaining customers expressed the desire to retain ownership of their UPS stock, at least “for the time being.” He maintained, however, that they never told him they were unwilling ever to sell their shares.¹⁹

The Extended Hearing Panel finds credible Respondent’s testimony that the complaining customers informed him they were willing to accept his recommendations to diversify and to sell UPS stock. E-mail messages and ACT notes, detailed below, corroborate Respondent’s accounts of conversations he had with some of the complaining customers on these points. Furthermore, the evidence shows that the complaining customers had previously pledged UPS stock as collateral for loans, and that some of them had sold UPS stock outright to pay debts or finance purchases. These facts support the reasonableness of Respondent’s conclusion that the complaining customers were not, as alleged, unalterably opposed to selling shares of UPS.

It is also significant that the complaining customers approached Respondent to help them write covered calls.²⁰ The evidence shows that most of the complaining customers initially learned about covered call writing from others, not Respondent, and contacted him so that they, like their friends and colleagues, might supplement their UPS dividends with premiums from the sale of covered calls. Furthermore, the evidence clearly shows that the complaining customers

¹⁷ Respondent’s testimony was consistent with an answer he gave to an Enforcement request for information long before the hearing, in which he said all but approximately 10 of his customers followed his advice early in their relationship and sold substantial portions of their UPS stock in order to diversify. Tr. 789-90; CX-2a, p. 3.

¹⁸ Tr. 817-18. In this regard, Respondent’s testimony at the hearing was consistent with his investigative testimony where, for example, he testified that because he knew his customers were “sensitive” about selling their UPS stock, he made a conscious effort not to push them into selling the stock immediately. CX-3, p. 44, sub-pages 774-75.

¹⁹ Tr. 788, 792. Respondent conceded that for an investor unwilling to sell shares of a particular stock, it would be inappropriate to repeatedly write covered calls in the money or deep in the money. Tr. 823-24.

²⁰ This is not dispositive, however, for a recommendation is not deemed suitable simply because a customer acquiesces in it; it must serve the customer’s best interests. *Scott Epstein, supra* at *39 (Jan. 30, 2009), *citing Raghavan Sathianathan*, Exch. Act Rel. No. 54722, 2006 SEC LEXIS 2572 (Nov. 8, 2006).

continued to roll calls forward, and to write new calls, even after the exercise of their calls brought home to them the lesson that writing calls meant they might have to sell the underlying stock.

D. The Complaining Customers Understood Covered Call Writing and the Risks

The five complaining customers who testified at the hearing claimed that they did not understand the risks inherent in writing covered calls because Respondent assured them there were none.²¹ However, before they could write covered calls, all of the complaining customers signed a document stating that they received and reviewed copies of written materials explaining the risks, and that they understood those risks.²² The document, an “Option Information” form, contained the following language:

I acknowledge receiving and reviewing the Options Clearing Corporation publication entitled Characteristics and Risks of Standardized Options, and I’m aware of the special risks attendant to options trading. The statements contained on this form are accurate.²³

Thus, all of the complaining customers signed a form confirming they had reviewed the informational booklet and were aware of the risks of options trading. Nevertheless, the complaining customers claimed that (i) they did not understand the statement they signed, (ii) they did not read the explanatory booklets Respondent and Merrill sent to them, or (iii) if

²¹ For example, AW testified that Respondent told him there was “no risk” involved in making covered calls, Tr. 577-78, 586, 591, that he would make more money from covered calls than just from dividends, and that he would never lose any of his UPS shares. Tr. 657-58. AW’s son, JW, echoed his father’s claims, Tr. 453-54, 464, as did AW’s daughter, MS. Tr. 299. CF claimed Respondent told her she could not lose money writing covered calls and there was no risk, Tr. 185-86, and FH testified he could not recall Respondent ever mentioning risks. Tr. 1816-17.

²² It is worth noting that Respondent’s expert, French, testified without challenge that the Merrill “Guide to Writing Stock Options” and the booklet “Characteristics and Risks of Standardized Options,” both of which were provided to all of the complaining customers, provide clear and complete disclosure, in understandable terms, about how covered call writing works. Tr. 1440-41.

²³ The signed acknowledgments are: AW, CX-13e; JW, CX-13a, p. 1; MS, CX-12a, pp. 1-2; CF, CX-9c, p. 4; FH, RX-223; JC, CX-8d; SR signed two acknowledgments, CX-11b, p. 1, and CX-11g, p. 1.

they did read the booklets, they did not understand them.²⁴ They claimed, in essence, that they were completely ignorant of how covered calls work.²⁵

In contrast, Respondent testified that when the complaining customers initiated the discussion of writing covered calls, he explained the strategy to them.²⁶ He emphatically denied telling any customer that there was no risk in writing covered calls,²⁷ or that they could write calls without obligating themselves to sell the stock if the calls were exercised.²⁸ In fact, Respondent testified that it was his habit and custom to advise all customers of the risks both orally and by providing written materials,²⁹ and to tell them that they should write calls only on stock they were willing to part with and set strike prices at which they were willing to sell.³⁰ He explained the importance of UPS dividend dates, and that the risk of the calls being exercised

²⁴ AW claimed that Respondent told him the forms were “all legalese” that he had to “go through.” Tr. 716-17. Even though he remembered the booklet because the lawyer who represented him in the arbitration claim authored it, AW denied reading it. Tr. 718-19. JW read the acknowledgment before signing it, Tr. 513, and read the booklet but claimed he did not understand the part of it that explained the requirement to deliver stock to the purchaser of a covered call who exercised the call. Tr. 512, 514. MS testified she did not read the “fine print” in the acknowledgment, and did not read the booklet. Tr. 390-91. CF testified that she did not read the booklet and did not even recall receiving it. Tr. 257-58. FH testified he reviewed the booklet but did not understand it, and that he signed the acknowledgment because it was “the only way” he could write covered calls. Tr. 1882. When FH was asked to read the acknowledgment aloud, he omitted the line that states “and am aware of the special risks attendant to options trading.” Tr. 1876-78. It did not appear to the Extended Hearing Panel that his omission was inadvertent.

²⁵ AW said he never grasped how he made money from covered calls. Tr. 585-86. JW claimed he understood neither the risks of the strategy nor the written materials he received from Respondent and Merrill explaining covered calls. Tr. 452, 518, 526. MS testified she never understood covered calls and when she spoke with her father and brother about them “it was like talking to dumb and dumber.” Tr. 298, 308. CF claimed that she complained to Respondent that she did not understand how covered calls worked, and that her “mind can’t wrap its head around covered calls.” Tr. 184-85, 237. FH testified he never understood Respondent’s explanations of strike prices or expiration dates, and claimed that when he asked Respondent questions about covered calls, he did not get “a straight answer.” Tr. 1816-19.

²⁶ Tr. 786-87.

²⁷ Tr. 1605, 1724, 1729.

²⁸ Tr. 1605, 1663-64.

²⁹ Tr. 1609-13. Respondent testified that he made sure his customers received the booklet titled “Characteristics and Risks of Covered Call Writing,” the Merrill “Guide to Writing Stock Options,” and another Merrill publication on the risks of options trading.

³⁰ Tr. 1620-21.

was greater as a dividend date approached.³¹ He told the complaining customers that their calls could be exercised whenever they were in the money.³² According to Respondent, none of the complaining customers told him they did not understand covered call writing or the risks the strategy entailed.³³

The Extended Hearing Panel credits Respondent's claim that it was his habit and custom to fully inform his customers about covered call writing and its inherent risks, including the risk that they would be required to sell their stock if the calls were exercised.

As corroboration, Respondent presented testimony from three unrelated, non-complaining customers and affidavits from 19 others³⁴ whose backgrounds and experience are similar to those of the complaining customers.³⁵ All three testifying customers acquired their UPS stock through their employment. Like the complaining customers, they have varying levels

³¹ Tr. 1668-70.

³² Tr. 1671-72.

³³ Tr. 1607.

³⁴ Respondent sought to present the testimony of 34 non-complaining customers, whose investments with Respondent are not the subject of this Complaint, to testify about what Respondent told them of the risks of writing covered calls. Enforcement objected on the grounds that the testimony would be irrelevant and cumulative. *See* Enforcement's Motion to Exclude Testimony of Certain Witnesses of Respondent (Dec. 21, 2009). Based upon Respondent's representation that it was his habit and custom to disclose the risks of covered call writing to all of his customers, and the authorities both parties cited, the Hearing Officer denied Enforcement's motion to exclude testimony of non-complaining customers and permitted Respondent to present such testimony from three witnesses. *See* Order Granting in Part, and Excluding in Part, Complainant's Motion to Exclude Testimony (Feb. 17, 2010).

In light of the limitation on the number of defense witnesses who would be permitted to testify, at the hearing Respondent offered affidavits from 29 additional non-complaining customers. After reviewing the affidavits, the Hearing Officer admitted 19 affidavits from customers similarly situated to the complaining customers for the purpose of establishing that it was Respondent's custom and habit to warn such customers who were interested in covered call writing of the risks inherent in that strategy. The Hearing Officer sustained Enforcement's objections to the remaining proffered affidavits on the ground that their contents exceeded the narrow scope deemed admissible. Tr. 897-908.

³⁵ Two of the three non-complaining customers who testified on Respondent's behalf are UPS managers with 22 and 31 years of experience respectively. Tr. 2064-65, 2205. The third retired as a UPS division manager after 26 years of employment with the company. Tr. 2185-86.

of formal education.³⁶ Like the complaining customers, they learned about covered call writing from friends and colleagues and told Respondent of their interest in engaging in writing covered calls.³⁷

Respondent advised all three to diversify their concentrated UPS positions.³⁸ As was the case with some of the complaining customers, although they were initially reluctant to sell shares of UPS, all three did so to diversify.³⁹ Each testified that Respondent explained clearly how covered calls worked, provided written explanatory materials, warned them of the risks and obligations attendant to writing calls, and advised them to set strike prices at a level at which they were willing to sell their shares.⁴⁰

The Extended Hearing Panel finds that these were credible witnesses whose testimony, supported by the affidavits, corroborates Respondent's claim that he advised the complaining customers of the risks of writing covered calls, as it was his custom and practice to do with all of his customers who were interested in this strategy.⁴¹

E. The Expert Testimony

Each party called an expert witness to render opinions about the nature of covered call writing, its risks, and suitability considerations pertaining to the complaining customers. The experts were in substantial agreement. For example, they agreed that covered call writing is

³⁶ One of the current UPS managers has a bachelor's degree in business management, Tr. 2086; the other has an associate's degree in criminology and a bachelor's degree in political science, Tr. 2226; and the retiree is a high school graduate, Tr. 2199.

³⁷ Tr. 2068-69; Tr. 2207, 2209. Tr. 2189.

³⁸ Tr. 2067, 2087 (WD); 2207-08 (DC); 2187 (TF).

³⁹ One testified that he struggled with the prospect of selling UPS shares. Tr. 2087. Over time, another was able to reduce his emotional attachment to his UPS stock and allow shares to be called away, and use the proceeds to diversify. Tr. 2223. Similarly, the retiree at first did not wish to sell UPS shares, but working with Respondent, slowly diversified. Tr. 2188.

⁴⁰ Tr. 2070-77, 2079, 2083-84 (WD); 2211-12, 2214-15, 2223-26 (DC); 2190-02 (TF).

⁴¹ The Extended Hearing Panel finds that the 19 affidavits admitted into evidence also corroborate Respondent's testimony that it was his habit and custom to advise customers of the risks of writing covered calls. *See* RX-196A.

fundamentally a conservative strategy.⁴² Both experts testified that for an investor with a large, concentrated position in a single stock, writing covered calls may be helpful as a step towards the desirable goal of diversification because writing covered calls requires setting strike prices at which the investor is willing to sell the stock.⁴³ As noted above, Respondent testified that this was one of his reasons for believing covered call writing was appropriate for the complaining customers.

However, Enforcement’s expert, Marc Allaire, opined that covered call writing was unsuitable for the complaining customers. Allaire reasoned that covered call writing is unsuitable for anyone unwilling to sell the underlying stock.⁴⁴ Because the complaining customers repeatedly rolled their calls forward in the money, and incurred losses by doing so, Allaire assumed that they must have been unwilling to sell the underlying stock.⁴⁵

The key to Allaire’s opinion was this assumption. In his words, Respondent’s recommendation to engage in covered calls “was unsuitable for these clients *assuming that they did not want to sell their shares.*”⁴⁶

Allaire conceded that the covered call writing in this case would not have been unsuitable if: (i) Respondent fully explored the notion of selling their underlying shares with his customers; and (ii) the customers told Respondent, and he satisfied himself, that they were willing to sell the shares.⁴⁷ The Extended Hearing Panel finds that Respondent did both.

⁴² Tr. 1182 (Allaire); 1411 (French).

⁴³ Tr. 1352 (Allaire); 1410 (French).

⁴⁴ Tr. 1193-95.

⁴⁵ “The trading pattern of the seven complaining investors clearly indicates that they had no intention of selling their UPS shares.” CX-36, p. 7; Tr. 1263. Allaire stated that he believed this to be especially obvious when the price of UPS was rising. CX-36, p. 7.

⁴⁶ Tr. 1293 (emphasis added). Allaire went on to say “I believe it is the responsibility of the financial advisor to find out if a client is comfortable selling shares before entering into the strategy.”

⁴⁷ Tr. 1293. Allaire testified that under these circumstances he would expect the trading record to look different.

Challenging Allaire, James French testified on Respondent's behalf that the pattern of the complaining customers' trading by itself does not prove that they were unwilling to sell the UPS shares covered by the calls. This is because the trading pattern does not disclose what the customers thought about selling their shares when they wrote their calls, or what changed conditions they may have considered when they later chose to roll them forward. French pointed out that people change their minds based on a wide array of variables not disclosed solely by the trading pattern.⁴⁸ In French's view, if a person sells a covered call option contract knowing that the call may be exercised, as the complaining customers did, that person is by definition not unalterably opposed to selling the underlying stock.⁴⁹

Thus, the difference between the expert opinions in this case as to whether covered call writing was suitable for the complaining customers depends upon whether the customers were willing to sell shares of their UPS stock. The Extended Hearing Panel finds that Respondent had a reasonable basis for believing that the complaining customers were willing, even if reluctant, to sell UPS stock and to accept his repeated recommendations to diversify their concentrated UPS positions. After careful consideration, therefore, the Extended Hearing Panel finds that Allaire's testimony, considered in its entirety, does not support the allegations in the Complaint that Respondent made unsuitable recommendations to the complaining witnesses.

⁴⁸ Tr. 1453-54.

⁴⁹ Tr. 1560-62. The Extended Hearing Panel finds reasonable French's conclusion that when the complaining customers wrote calls, rolled them forward, and eventually let their stock get called, the diversification recommended by Respondent was accomplished. Tr. 1459-60. French was also persuasive in his critique of the language in the Complaint alleging that the covered call writing strategy was unsuitable in the context of the "rising UPS market," because it is impossible to predict whether a market for a particular stock will rise or fall in the future. Tr. 1478, 1529. Finally, French testified that, in his opinion, the publications on options that Respondent and Merrill sent to the complaining customers are clear, complete, and readily understandable. Tr. 1440-41.

F. The Issue of Losses

As noted above, Enforcement contends that the complaining customers cumulatively suffered losses in excess of \$4 million. The evidence in this case does not support Enforcement's claim of such substantial losses. Indeed, the Extended Hearing Panel finds that the evidence shows that the covered call writing of the complaining customers was, for the most part, profitable. The Extended Hearing Panel finds French's analysis to be persuasive. In the accounts of the complaining customers, French calculated that the only loss was in AW's account, in the amount of \$65,221.03, but that AW's wife's two accounts reflected gains of \$245,775.82 and \$47,941.71. French found that the complaining customers earned substantial gains from their covered calls.⁵⁰ French's calculations took into account the rise and fall in the market value of the underlying UPS stock in the covered calls, which the Extended Hearing Panel finds proper.⁵¹ Both experts agreed that the complaining customers would have made additional gains if they had persevered in the strategy long enough.⁵² French also opined persuasively that if the complaining customers had heeded Respondent's advice to give up their stock when it was called, they would have been better off financially.⁵³

G. The Complaining Customers

A number of the complaining customers are related. Of the five who testified, three are family members: MS is AW's daughter and JW is AW's son. In addition, FH is a good friend of

⁵⁰ Tr. 1506-07.

⁵¹ Tr. 1481-83. French calculated the gains to be: for JW: \$22,524.67; MS: \$5,360.88; CF: \$22,359.62; FH: \$55,328.50 in his account, and \$44,389.32 in his wife's account; JC: \$126,006.23 in his account, \$44,365.19 in his wife's account, and a loss of \$4,105.59 in a joint account; SR \$5,341.79, and \$120,727.85 in a joint account.

⁵² Tr. 2367 (Allaire); Tr. 1523-28, 1587-88 (French).

⁵³ Tr. 1587-88. However, gains or losses do not determine whether a trading recommendation is suitable. *See Raghavan Sathianathan*, Exch. Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *32 (Nov. 8, 2006) (overall performance of stock market does not affect suitability of recommendations).

AW and the two have mutual acquaintances.⁵⁴ The two non-testifying complaining customers are also from the same family: JC is SR's uncle.⁵⁵ Just before the hearing, at the Final Pre-Hearing Conference, Enforcement announced that JC and SR would not appear. Enforcement elected not to request leave to present the testimony of either one by telephone.⁵⁶

Because the Complaint alleges Respondent's recommendations were unsuitable for each individual complaining customer, the Extended Hearing Panel analyzed the circumstances and testimony of each one in light of the suitability requirements FINRA rules imposed upon Respondent as a registered representative.

1. AW

AW began working for UPS after graduating from high school.⁵⁷ He subsequently went into management and progressed to the position of division manager, responsible for 40 to 60 drivers, 30 night employees, and 30 part-time employees in four separate locations.⁵⁸ After 35 years, he retired in May 1994, at age 55.⁵⁹ By the time he retired, AW had accumulated a substantial position in UPS shares which, when he began writing covered calls with Respondent, was worth over \$13 million.⁶⁰

⁵⁴ Tr. 284-85, 440-41. The evidence shows that AW, MS, and JW discussed their covered call writing and their complaints about Respondent's recommendations with each other. FH and AW discussed covered call writing with each other and with mutual friends. JC and SR spoke about the strategy with each other and together spoke with Respondent on a number of occasions. The Extended Hearing Panel finds this helps to explain the significant consistencies in their testimony.

⁵⁵ Tr. 1736-37.

⁵⁶ Enforcement proffered that one was seriously ill and had broken off contact, and the other was "upset" and would not testify in person. Transcript of Final Pre-Hearing Conference, pp. 23-26 (Feb. 18, 2010).

⁵⁷ Tr. 569.

⁵⁸ Tr. 569-70.

⁵⁹ Tr. 573.

⁶⁰ After the stock split in 2002, AW owned 238,000 shares. On February 1, 2002, the market price per share of UPS was \$56.79. RX-186A. As a result, AW's UPS shares at that time were worth approximately \$13.5 million.

After retiring, he received approximately \$300,000 annually from dividend payments from his UPS stock, in addition to his company pension. Tr. 574.

AW testified initially that he had always wanted to preserve his UPS stock so that he could give some to his children while he was still living and bequeath the remainder to them upon his death.⁶¹ However, AW sold shares valued at \$2.7 million to purchase homes in Florida and New York. He also took out a \$1.8 million loan at Merrill using UPS stock as collateral, knowing that if he failed to pay the loan, Merrill could take the stock.⁶²

AW's Decision to Write Covered Calls

AW testified that he first learned about covered call options from his friend and former UPS colleague, NA, with whom he played golf.⁶³ It was at NA's suggestion that AW called Respondent to write covered calls.⁶⁴ AW testified that NA told him that "dividends are not enough" and that covered calls were a "great way to make money."⁶⁵ AW said he "wanted to get into this covered call thing, because everybody else was getting cash."⁶⁶

According to AW, his initial conversation with Respondent about covered calls was short.⁶⁷ AW insisted that he was "emphatic" in informing Respondent that he did not want to sell any of his UPS stock.⁶⁸

At first, the calls AW wrote expired without being exercised, and AW routinely wrote new calls.⁶⁹ Happy with the premiums, AW called his son JW, and his daughter MS, and

⁶¹ Tr. 625. AW testified he had given approximately 35,000 shares of UPS to his children. Tr. 594-95.

⁶² Tr. 714.

⁶³ Tr. 574-76, 707-08.

⁶⁴ Tr. 579. AW met Respondent through Respondent's father, W. Respondent, who had prepared AW's taxes for years. Tr. 579-80. Before Respondent became AW's investment advisor, W. Respondent recommended that AW diversify, and gave AW a written outline of a diversification strategy. Tr. 700-05.

⁶⁵ Tr. 576.

⁶⁶ Tr. 579. AW said that NA told him that one week he had made \$1,500, and a few weeks later he made an additional \$2,500 from covered calls. Tr. 576.

⁶⁷ Tr. 578.

⁶⁸ Tr. 578, 586, 591.

⁶⁹ Tr. 671.

recommended that they contact Respondent so that they, too, could make extra money by writing covered calls on the shares of UPS stock he had given them.⁷⁰

AW Understood Covered Call Writing

Despite claiming that he did not read, and could not understand, the written materials from Merrill explaining the risks of covered call writing, AW appeared to be conversant with the principles of covered call writing described in the publications. For example, he understood that if he wrote a call with a strike price at \$60, and the market price of the stock rose to \$70, he would not be entitled to any of the gain in value above \$60.⁷¹ AW conceded that he “probably” understood, when writing calls, that if the market price of the stock rose above the strike price he set on covered calls, it was disadvantageous to him.⁷² AW also understood what “rolling a call” entailed and that he could earn larger premiums by rolling a call forward for a longer period than for a shorter period.⁷³

AW testified initially that Respondent called him in November 2003 to inform him the first time his covered calls had been exercised. AW testified that he told Respondent “you can't sell my shares.”⁷⁴ After Respondent explained that there was a “procedure,” called “buy-write,” by which AW would be able to purchase back the shares that had been called and obtain preferential tax treatment for the transaction, AW reacquired the UPS shares that had been called.⁷⁵

⁷⁰ Tr. 595-96.

⁷¹ Tr. 723.

⁷² Tr. 752.

⁷³ Tr. 693-94. He also understood that if a purchaser paid \$1 for a call when the price of the stock was \$60 per share, the value of the call increased to \$5 when the share price rose to \$65. Tr. 695-96.

⁷⁴ Tr. 592-93.

⁷⁵ Tr. 593.

In fact, AW first had calls exercised eight months earlier, in March 2003.⁷⁶ Prior to that time, AW apparently did not expect his shares would be called. AW testified that “from all the people that I talked to that were in it ... nobody had their stuff called.”⁷⁷ When AW’s calls were exercised, he testified, Respondent explained the available alternatives. Although AW relied on Respondent’s input, AW conceded it was he who decided what to do.⁷⁸ As the price of UPS stock continued to rise higher than AW’s strike prices, he knew the price disparity was disadvantageous.⁷⁹ Yet he continued to write covered calls, apparently because “[e]verybody knew that the price [of UPS stock] was inflated, that it was going to come back down.”⁸⁰

AW received a letter from a Merrill administrator, dated September 24, 2003, stating that he had sustained realized losses in excess of \$500,000 in trading from January 1, 2003, through August 29, 2003.⁸¹ AW claimed that the letter conflicted with Respondent’s assurances that he had been making money through his covered calls. Upset, AW testified that he contacted Respondent who reassured AW and suggested he disregard the letter.⁸² Respondent said he would pay AW and his wife a visit to discuss the situation. He did so on November 1, 2003, at AW’s home.⁸³

When they met, AW tape recorded the ensuing conversation.⁸⁴ Most significantly, in the course of the conversation, AW articulated a clear understanding of how a covered call writer

⁷⁶ Tr. 665-66.

⁷⁷ Tr. 668.

⁷⁸ Tr. 679.

⁷⁹ Tr. 752.

⁸⁰ Tr. 753.

⁸¹ CX-17.

⁸² Tr. 599.

⁸³ Tr. 600-03; CX-16.

⁸⁴ Tr. 603-04. Respondent disputed this. According to Respondent, the recording was made without his knowledge or permission. Tr. 871. However, Respondent did not object to its introduction. Tr. 620-21.

runs the risk of “opportunity loss” in a rising market. This occurred when AW’s wife asked how much she and AW would lose if they let the shares covered by the calls that had been exercised be sold. In answer, AW said: “We wouldn’t have lost anything. We’d have lost the gain from the 55 to the 72,” meaning the loss of the appreciation of the UPS share price from the \$55 strike price of their calls to the then-current \$72 market price.⁸⁵ The Extended Hearing Panel finds that AW’s analysis of the “loss” as an opportunity loss was accurate and reflected AW’s understanding of the somewhat sophisticated concept of how a writer of covered calls may not participate fully in an increase in the market price of the stock for which he has written calls.

Respondent Advised AW to Diversify

Respondent’s testimony that he consistently recommended that AW diversify is corroborated by a memorandum that Respondent’s father had prepared previously for AW that outlined a diversification strategy.⁸⁶ Early in their relationship, Respondent and AW reviewed the memorandum and, as a result, Respondent said he believed that AW knew he should diversify,⁸⁷ and that he agreed to do so, although not immediately.⁸⁸

ACT notes created well before any of AW’s calls were exercised corroborate Respondent. For example, an ACT note dated September 20, 2002, refers to a discussion in which AW acknowledged he needed to diversify but confessed that he was being “a pig” about the premiums, meaning that he was reluctant to give them up.⁸⁹ A September 24, 2002, ACT note reflects that Respondent left a message for AW in which Respondent recommended that

⁸⁵ CX-16, p. 44. By this statement, AW demonstrated that he understood the loss he had incurred was the loss of the opportunity to gain that worked to his disadvantage when the market price of UPS stock rose above the strike price, the upside “opportunity” cost that profited holders of unencumbered UPS shares.

⁸⁶ RX-58.

⁸⁷ Tr. 1676.

⁸⁸ Tr. 1052, 1675. In repeated discussions about the importance of diversification, Respondent testified that AW said he understood the need to diversify. Tr. 1053, 1675-76.

⁸⁹ Tr. 1696-97; RX-12.

AW improve his strike price on his covered calls, roll them up out of the money, and set an appointment to further discuss diversification.⁹⁰ Additional ACT notes in October and November 2002, and in 2003, echo AW's acknowledgments of the need to diversify, and admissions that he was stubbornly insistent on attempting to collect premiums from covered calls.⁹¹

AW Admitted Responsibility for His Covered Call Writing

Finally, on several occasions, AW admitted that he, not Respondent, was responsible for deciding to write and roll forward calls in the money as UPS's share price rose, which was costly and contrary to Respondent's advice to diversify. The first occasion, according to Respondent, was at the conclusion of the November 1, 2003, meeting at AW's home. AW acknowledged that he had gotten himself into a "mess" by rolling his calls instead of selling his stock.⁹²

AW expressed similar sentiments to Respondent's father in a conversation that occurred after more of AW's calls had been exercised. In a conference call in November 2004, AW

⁹⁰ RX-12. AW responded that he appreciated the advice. RX-12; Tr. 1701-02. However, AW ignored it. Tr. 1699.

⁹¹ For example, in October 2002, Respondent advised AW to roll his covered call strike prices up, collect an 80-cent premium, and start diversifying. AW declined, stating that he had reviewed available options prices and wanted to earn a larger premium of \$1.50. Respondent noted that AW admitted again he was being a "pig" about premiums. Tr. 1703-05; RX-12, p. 006820 (10/18/02 and 10/22/02). An ACT note dated June 25, 2003, reflects the ongoing nature of Respondent's conversations with AW about diversification. In it, Respondent refers to a "long talk" with AW in which AW said he was "getting close" to diversifying, mentioning that one of his relatives had recently lost his entire net worth because his money had been concentrated in Lucent Technologies. RX-10, p. 001294; Tr. 1707. Respondent testified that he used the examples of Lucent, WorldCom and Enron in his efforts to persuade the complaining customers to diversify. Tr. 1602, 1664-65. Again, in November 2002, Respondent advised AW to move his strike prices up, rather than to roll them forward in the money. This time, AW added calls with higher strike prices as a hedge against other calls with lower strike prices that he retained. Tr. 1705-06; RX-12, p. 006820 (11/27/02). In March 2003, when AW told Respondent he wanted to write additional calls at a lower strike price, Respondent advised AW against doing so, and said he thought AW was getting "carried away" with writing calls to collect premiums. In this instance, AW accepted Respondent's advice. Tr. 1649-51; RX-10, p. 001294 (3/7/03). Similarly, on August 28, 2003, an ACT note indicates Respondent advised AW against selling additional calls, warned AW he was going "overboard," and that AW admitted that he was doing so, and that he had been, once again, a "pig." RX-10, p. 001292 (8/28/03).

⁹² This statement was not recorded because it was made outside AW's house as Respondent was leaving. Tr. 799-800. However, Respondent memorialized it in an ACT note, dated November 3, 2003, in which he wrote that AW said "I got myself into this mess" by selling covered calls. Tr. 798; RX-10, p. 001291 (11/13/03).

described himself as a “big boy” and said that he had known what he was doing when he wrote covered calls.⁹³

WA, a former Merrill colleague of Respondent's, participated in that conference call. WA had to leave the conversation for a few minutes and did not hear AW's “big boy” statement but testified that he heard AW make other admissions. According to WA, AW admitted that he had been “greedy” about the premiums and had been “burying his head in the sand” as UPS's share price had risen above AW's strike prices.⁹⁴ A corroborative ACT note of the conversation, dated November 15, 2004, states: “Spoke to Bill and [AW] agreed he should sell the stock and admitted he had been greedy with the calls.”⁹⁵ WA understood AW to mean that he had been greedy in the past in wanting to make as much cash as he could from premiums, and now he was being greedy about wanting to participate in the upside increase in the market price of the stock.⁹⁶ WA testified that AW did not seem angry or upset. AW did not blame anyone other than himself and said nothing about not having previously understood that covered calls can be exercised by the purchasers.⁹⁷ Indeed, in all of their conversations, AW appeared to understand that by writing covered calls, he risked the possibility of having to sell his stock.⁹⁸

2. JW

At the time of the hearing, AW's son, JW, was 40 years of age and unemployed. He has an undergraduate degree in business. He worked for AT&T from 1998 through 2007. While at

⁹³ Tr. 1960-61.

⁹⁴ Tr. 1998-99.

⁹⁵ Tr. 2000-02; RX-13, p. 006807(11/15/04).

⁹⁶ Tr. 2049.

⁹⁷ Tr. 2049-51.

⁹⁸ Tr. 2051.

AT&T, JW obtained an MBA and a master’s degree in telecommunications.⁹⁹ He left AT&T to become vice president of marketing and sales for a start-up software company, where he remained for almost two years.¹⁰⁰

JW testified that he viewed his UPS stock as being “better than gold” because it “always went up in value.”¹⁰¹ He testified that he wanted to reap the value of the dividends, using them for vacations and to pay for “extras,” and pass the stock to his children.¹⁰²

As a consequence, before opening his account with Respondent, JW had never sold his UPS stock.¹⁰³ He did, however, use the stock to borrow money. He had a loan with Merrill secured by the stock and understood that if the market price of UPS fell, Merrill could require him to encumber additional shares of the stock as collateral.¹⁰⁴

JW testified that he had no investment experience prior to opening his account with Respondent at Merrill.¹⁰⁵ However, on the account opening documents for the Merrill account, JW indicated that he had one year of investing experience with “moderate prior trading activity,” and listed his investment objectives as income, hedging and speculation.¹⁰⁶ The form states that JW had one year of experience trading options, specifically covered calls, but he testified that was based on what he knew his father had been doing with covered calls.¹⁰⁷

⁹⁹ Tr. 437-38.

¹⁰⁰ Tr. 438-39.

¹⁰¹ Tr. 440-41.

¹⁰² Tr. 441-42, 441.

¹⁰³ Tr. 441.

¹⁰⁴ Tr. 542-44.

¹⁰⁵ Tr. 442-43.

¹⁰⁶ Tr. 448-49; CX-13a, p. 1.

¹⁰⁷ Tr. 450.

JW testified that Respondent advised him that writing covered calls was “a no risk strategy that was great for cash flow,” which was what interested him.¹⁰⁸ JW testified that Respondent told him there “wasn’t a down side” to covered call writing,¹⁰⁹ and he would not have to sell his UPS shares.¹¹⁰ JW claimed he always followed Respondent’s recommendations.¹¹¹

JW’s Understanding of Covered Calls

Although he claimed he did not understand covered calls,¹¹² JW’s testimony reflects an understanding of basic aspects of covered call writing. For example, he knew that setting the strike price closer to the market price of the stock could increase the premiums from the sale of a covered call,¹¹³ and that setting the strike price further away from the market price could reduce the premiums.¹¹⁴ JW testified that he was conservative in setting the strike prices for his covered calls.¹¹⁵

JW said that sometimes his father told him of calls he had written, and JW in turn directed Respondent to write the same calls for him.¹¹⁶ Although JW claimed that he did not coordinate trades with his sister and father, he admitted that they talked about trades that they

¹⁰⁸ Tr. 453.

¹⁰⁹ Tr. 454.

¹¹⁰ Tr. 464.

¹¹¹ Tr. 456, 468.

¹¹² Tr. 452, 518, 526.

¹¹³ Tr. 491.

¹¹⁴ Tr. 492.

¹¹⁵ *Id.*

¹¹⁶ Tr. 457, 461.

had just made or planned to make. Thus, he was not surprised that sometimes the three of them executed identical trades.¹¹⁷

JW earned over \$20,000 from three covered calls in 2003 and 2004, and believed writing covered calls was generating cash for him.¹¹⁸

JW testified that at the end of 2004, like his father, he had "lost confidence" in Respondent, found it difficult to reach him, and therefore stopped using him as his financial advisor.¹¹⁹ In 2005, with his father and sister, he turned to an attorney to pursue action against Merrill and Respondent.¹²⁰

Respondent testified that he warned JW of the risks when he expressed interest in writing covered calls as his father was doing. Specifically, Respondent warned him against capping his potential upside and leaving his downside unprotected, recommended that he diversify and use the premiums he earned from covered calls to do so.¹²¹ Respondent denied telling JW that there was no risk his stock could be called away,¹²² and denied that JW said he was unwilling to sell his UPS stock.¹²³ Respondent testified that when JW lowered his strike prices, to increase the premiums, he did so against Respondent's advice.¹²⁴

Although Respondent made ACT notes of his conversations with JW, most of them were deleted by a colleague without Respondent's knowledge.¹²⁵ A note entered on July 14, 2004,

¹¹⁷ Tr. 546-48. JW also testified that he, AW, and MS discussed the questions they would be asked when they testified at the hearing of this case. Tr. 464.

¹¹⁸ Tr. 469-70.

¹¹⁹ Tr. 471.

¹²⁰ Tr. 473. JW filed a claim with Merrill for a loss of \$158,815.33. Tr. 548.

¹²¹ Tr. 1717-19.

¹²² Tr. 1724.

¹²³ Tr. 1722-23.

¹²⁴ Tr. 1723.

¹²⁵ Tr. 1721-22.

however, shows that WA, consistent with the advice Respondent was giving JW, advised JW to let calls that were assigned be sold and use the proceeds to reinvest and to increase the strike prices on his other calls.¹²⁶

3. MS

AW's daughter, MS, is 47 years old, married with two children, and has an associate's degree in business management.¹²⁷ She is an agent for a life insurance company where she has worked for 11 years.¹²⁸ MS possesses two securities licenses, a Series 6 and a Series 63, which permit her to sell mutual funds and variable annuities.¹²⁹ Despite the fact that she is "in the business," MS testified that her investment experience was limited. MS said that she had no experience trading options prior to writing covered calls with Respondent.¹³⁰

MS testified that when she received her gift of UPS stock from AW, it came with a letter asking his children not to sell the stock.¹³¹ Despite this, MS sold some shares to use for a college tuition payment for her son.¹³²

Like her brother, MS contacted Respondent after learning that her father was gaining extra income through covered calls.¹³³ She wanted to do the same, without having to sell the stock, and use the additional income for expenses.¹³⁴

¹²⁶ RX-3, p. 006832 (7/14/04).

¹²⁷ Tr. 281.

¹²⁸ Tr. 282.

¹²⁹ Tr. 361.

¹³⁰ Although her husband had an online trading account for four years, MS said she did no trading in it. Tr. 288, 295.

¹³¹ Tr. 285.

¹³² MS testified that she thought of investing in her son's education as a kind of diversification. Tr. 287.

¹³³ Tr. 290.

¹³⁴ Tr. 291-92.

MS claimed that she vividly recalls her first conversation with Respondent. MS said that it was in August 2003, when she was on vacation at the beach with her husband and had a conversation with JW about “all the money he was making with [Respondent].” She then called Respondent and asked if she could “generate income without selling any shares.”¹³⁵ According to MS, Respondent was “adamant” that she would not have to sell shares if she wrote covered calls.¹³⁶

Respondent testified that when MS called to express her interest in writing covered calls, he advised her that she should diversify in order to protect herself financially. Respondent said that MS told him that she was not opposed to selling her UPS stock, and said she had previously sold some of it.¹³⁷

Before MS wrote any calls, in addition to sending her informational materials about covered call writing, Respondent had more than one conversation with her about the strategy.¹³⁸ Respondent testified that he advised MS fully of all of the risks, including the risk that she might be required to sell her UPS stock if the share price rose. Like JW, MS gave no indication that she did not understand that this could occur.¹³⁹

MS began writing covered calls in 2003.¹⁴⁰ Respondent testified that when the price of UPS stock rose, and MS was in the money with her calls, he advised her to let the stock go or to

¹³⁵ Tr. 297, 303. MS's recollection is unreliable in this instance because, as noted below, she received a note from Respondent reflecting that they were discussing covered calls at least as early as 2001. It is noteworthy that MS became involved with covered calls as a result of conversations she had about them with her brother and father, and that her covered call activity commenced well after the date in March 2003 when AW first experienced having calls exercised, after which AW could be presumed to know first-hand the risk of having calls exercised.

¹³⁶ Tr. 298.

¹³⁷ Tr. 1726-27.

¹³⁸ Tr. 1728-29.

¹³⁹ Tr. 1728.

¹⁴⁰ Tr. 1728.

increase the strike price. She declined, however, because she was unwilling to pay out-of-pocket in order to roll up.¹⁴¹

On October 21, 2003, Respondent left a message for MS to let her know that a dividend date was approaching, which meant she was at risk of having her covered calls assigned.¹⁴² On November 17, 2003, when Respondent spoke with MS, an ACT note indicates she told Respondent that she was willing to take the risk of having the shares called, and would “wait it out.”¹⁴³ The following day, however, MS directed Respondent to roll the calls forward, exactly as her father and brother did at about the same time.¹⁴⁴

MS testified that she became concerned about her account after her father received the letter from Merrill. Shortly thereafter, in November or December 2004, she, AW, and JW ceased covered call writing.¹⁴⁵

4. CF

CF’s testimony demonstrated that she possessed a knowledge and understanding of covered call writing inconsistent with her protestation that her “mind can’t wrap its head” around covered call writing.¹⁴⁶ For example, although CF claimed not to understand what a strike price is, her testimony showed that she did.¹⁴⁷ Significantly, CF’s status as a “windowed employee” at

¹⁴¹ Tr. 1730.

¹⁴² Tr. 1731-32; RX-6, p. 0033297 (10/21/03).

¹⁴³ Tr. 1732; RX-6, p. 0033297 (11/17/03).

¹⁴⁴ Tr. 1733. Both AW and JW on occasion said to Respondent that they wanted to write a particular call because their father was doing so. Tr. 1734.

¹⁴⁵ Tr. 315.

¹⁴⁶ Tr. 184-85, 237.

¹⁴⁷ Tr. 194-95. CF’s testimony reflected her understanding that by writing a covered call she risked having to sell the stock if the call was exercised. She testified that writing a call at a strike price of \$60 meant that she was agreeing to sell it at that price. Tr. 239-40.

UPS, whose calls could be exercised only on a specified date,¹⁴⁸ required her to write European-style options.¹⁴⁹

CF testified that she became concerned about her covered call writing when UPS stock reached the high \$70’s and her strike price was \$60. She believed her choices at that point were to sell at the strike price, and “walk away from a couple hundred grand,” or to hold her position and hope the price came down.¹⁵⁰ After a year and a half, she decided to stop writing covered calls because, she testified, she did not want to “be sitting here praying that UPS stocks plummet.”¹⁵¹

CF made \$18,500 in premiums on her first covered calls.¹⁵² However, CF subsequently testified that when she decided to quit covered call writing, she “had to sell 10,000 shares.” Because she sold the calls at a strike price of \$60, for \$600,000, and because the market price was at \$78 or \$80, she thought she lost \$200,000 that she would have made had she been able to keep the shares and sell them at the market price.¹⁵³ CF said that she blamed herself as much as she did Respondent.¹⁵⁴ Her belief that she had lost money was part of her reason for deciding to find a different financial advisor.¹⁵⁵

¹⁴⁸ Tr. 241-42. As a windowed employee, UPS allowed CF to sell its stock at designated times, or windows, usually one week each quarter, so the date for exercise of her calls had to be within the windows. As a writer of a European-style call, therefore, CF was on notice that it could be called only on the expiration date, which reinforced the notion that writing a call may result in having to sell the underlying stock. Tr. 2150. An ACT note written by Respondent reflects a discussion with CF about the windows. Tr. 2150-53; RX-42, p. 006696 (4/28/03).

¹⁴⁹ Tr. 214, 241-42.

¹⁵⁰ Tr. 195.

¹⁵¹ Tr. 196.

¹⁵² Tr. 187.

¹⁵³ Tr. 202. CF acknowledged, however, that her cost basis for the stock was less than \$60, although she was unable to say whether it was “substantially” less. Tr. 202-03.

¹⁵⁴ Tr. 201.

¹⁵⁵ Tr. 201-02.

Finally, CF testified that Enforcement attorneys informed her, while preparing her for the hearing, that Respondent made commissions on the covered call writing, and when she learned this, she “got really mad.”¹⁵⁶

Respondent testified that from the start of his relationship with CF, he recommended that she diversify, and she agreed.¹⁵⁷ He was aware that CF used UPS stock as collateral for loans and to make purchases of real estate. For example, an ACT note by Respondent indicates that CF told him she purchased land in South Carolina in 2002.¹⁵⁸ In early 2003, CF directed Respondent to convert all of her Class A UPS shares to Class B, partly because she anticipated needing money to purchase additional real estate.¹⁵⁹

According to Respondent, CF contacted him in 2003 about writing covered calls. She, like the other complaining customers, knew of UPS stockholders who were engaging in the strategy.¹⁶⁰ Respondent testified that in the ensuing conversations, he advised CF of the risks, sent her informational materials, and from their discussions, believed she understood the risks. In contrast to CF’s testimony, Respondent testified she never indicated that she was confused or could not understand the strategy.¹⁶¹

¹⁵⁶ Tr. 260, 271. The record does not disclose what, if anything, Enforcement told CF about the amount of commissions Respondent made. MS testified she believed Respondent was motivated to recommend covered calls in order to generate commissions for himself, Tr. 411, and JW implied that he suspected so as well. Tr. 465. The uncontested evidence, however, shows that over the entire two-year period the complaining customers engaged in covered call writing, Respondent earned only \$2,943 in commissions from the complaining customers’ covered calls. Tr. 1145; RX-74. The Extended Hearing Panel finds no basis for concluding that Respondent was motivated by pursuit of commissions for himself when he recommended covered calls to the complaining customers.

¹⁵⁷ Tr. 2136.

¹⁵⁸ RX-42, p. 006696 (3/4/02).

¹⁵⁹ Tr. 2135-36; RX-40, p. 004269 (2/18/03).

¹⁶⁰ Tr. 2146. Respondent denied CF’s assertion in her testimony that he called her to say it was a good time to start writing covered calls. Respondent pointed out that there is no way he could know what would be a “good time” to start writing covered calls.

¹⁶¹ Tr. 2147-50.

CF sold her first covered calls in April 2003.¹⁶² They subsequently expired.¹⁶³ She then wrote new calls. Respondent recalled informing CF when her outstanding calls were about to expire, and then telling her when the calls were exercised. Respondent testified that when he called her about imminent expiration, CF said she knew the market price was higher than her strike price, but that she wanted to diversify.¹⁶⁴

On April 21, 2004, as reflected in an ACT note, Respondent and CF again discussed diversification in anticipation of the expiration of some calls, but CF did not wish to sell the shares at that point. CF suggested rolling forward to January 2005. In response, Respondent suggested a shorter-term roll, to October 2004, rather than to January 2005, in order to retain flexibility. CF accepted his advice, electing to roll the calls to October, for a smaller credit.¹⁶⁵

In July 2004, CF asked Respondent how much commission she would be charged for selling her shares. The ACT note he made of the conversation confirms that when he informed her it would be four cents per share, she replied that the charge was “nothing.”¹⁶⁶ Soon thereafter, on October 29, 2004, CF decided that she was going to let 10,000 shares of her UPS stock be called away. Once again, an ACT note shows that CF said that she was not concerned about the difference between the market price and her strike price, because she wanted “to diversify anyway.”¹⁶⁷ On November 1, 2004, Respondent left CF a message that the calls had been assigned, as anticipated, because the calls were in the money.¹⁶⁸ CF decided to let the

¹⁶² Tr. 2153-54.

¹⁶³ Tr. 2154.

¹⁶⁴ *Id.*

¹⁶⁵ Tr. 2155-56; CX-45, p. 006688 (4/21/04).

¹⁶⁶ Tr. 2157; RX-45, p. 006688 (7/22/04). This contradicts CF's claim, noted above, that she first learned from Enforcement that Respondent earned commissions on covered calls.

¹⁶⁷ Tr. 2157-58; RX-45, p. 006687 (10/29/04).

¹⁶⁸ Tr. 2159; RX-45, p. 006687 (11/1/04).

shares be called away at her strike price of \$60, well below the market price,¹⁶⁹ consistent with her general willingness to sell UPS stock.

CF sent an e-mail message several days after her calls were assigned and the stock was sold. In the e-mail, CF considered using the proceeds of the sale of her stock to diversify instead of reinvesting in calls. She mentioned her Merrill loan, educational expenses for a niece, taxes, credit card debt, car and boat loans, and a Mercedes Benz automobile she wanted to purchase. She concluded by outlining a proposal to sell her remaining shares of UPS stock in order to diversify her portfolio. Respondent testified that her proposal was precisely along the lines of his consistent recommendations.¹⁷⁰

5. FH

FH, the fifth complaining customer to testify, is a retired UPS employee who joined the company after a year of college and four years of experience in the Navy. He had worked for UPS for 32 years, first as a driver, then as a manager. When he retired from UPS at age 56 in 1995, he had acquired nearly 63,000 shares of UPS stock.¹⁷¹ FH testified that he had no prior investment experience when he began his association with Respondent.¹⁷²

FH talked about covered calls with his friend AW, as well as with AW's friend, NA. AW told FH he was making money through covered call writing with no risk, and FH wanted to do so as well.¹⁷³ That is why FH contacted Respondent.¹⁷⁴

¹⁶⁹ Tr. 2158-59.

¹⁷⁰ Tr. 2164-66; RX-152.

¹⁷¹ Tr. 1808-10.

¹⁷² Tr. 1834.

¹⁷³ Tr. 1839, 1842.

¹⁷⁴ Tr. 1812-13, 1911.

FH opened his account with Respondent in 2001 and began writing covered calls in September 2002.¹⁷⁵ As did the other complaining customers, FH wrote his first calls out of the money and they expired.¹⁷⁶ Thereafter, the stock price increased and FH began to roll his calls at lower strike prices, against Respondent’s advice, having gotten the idea to do so from AW.¹⁷⁷ Respondent urged him to raise the strike price. An August 13, 2003, ACT note corroborates Respondent’s testimony that he described to FH how to move the strike price higher.¹⁷⁸ FH experienced having his calls assigned for the first time on August 19, 2003, well before the expiration date of those calls.¹⁷⁹ Despite this experience, FH asked Respondent to continue to write calls for him.¹⁸⁰

FH claimed that when he asked questions about covered calls, Respondent did not give “a straight answer,” so FH did not “pay much attention to him.”¹⁸¹ Nonetheless, FH testified that he had no reservations about engaging in covered calls.¹⁸² Because he was “very, very protective” of his UPS stock, however, and because he was by his own description “very cautious,” FH deposited only a fraction of his UPS stock into his Merrill account for Respondent to invest,¹⁸³ an indication that FH understood the risks of covered call writing. Respondent knew FH was writing calls on only a small portion of his stock.¹⁸⁴ FH admitted that Respondent

¹⁷⁵ Tr. 2239; RX-181.

¹⁷⁶ Tr. 2240.

¹⁷⁷ Tr. 2241-42.

¹⁷⁸ Tr. 2244; RX-16, p. 004630 (8/13/03).

¹⁷⁹ RX-181, p. 11; RX-182, p. 9.

¹⁸⁰ Tr. 1844-46. FH claimed that he did so relying on Respondent’s advice, and that he “had no choice” but to do so. The Extended Hearing Panel did not find this claim credible, in light of Respondent’s testimony, and corroborative evidence, including the ACT notes.

¹⁸¹ Tr. 1817.

¹⁸² Tr. 1817-18.

¹⁸³ Tr. 1849-51, 1904.

¹⁸⁴ Tr. 1904, 1908-09.

advised him not to have all of his “eggs in one basket,” and urged him to diversify on more than one occasion, but testified that he told Respondent that he had “no intentions of diversifying.”¹⁸⁵

FH’s Understanding of Covered Calls

The evidence does not support FH’s claim that he did not understand covered call writing. For example, he knew that when his calls were exercised, he had to sell stock at the strike price. He knew this meant he lost the opportunity to continue to collect dividends from those shares, and that he was unable to profit from the difference between the strike price and the higher market price.¹⁸⁶ He understood that if he failed to roll a call forward, he was exposed to “having those shares bought by somebody ... exercising the calls.”¹⁸⁷ He understood that as long as the calls were outstanding, he still held the stock and collected the dividends.¹⁸⁸

Even though FH claimed he was unable to understand Respondent’s explanations of covered calls, FH learned from Respondent that the strike price was the price at which someone could purchase the stock subject to the covered call.¹⁸⁹ FH also testified that he knew that if his call was exercised, and the buyer took the shares, he could repurchase the shares and obtain a tax benefit, if he did so immediately,¹⁹⁰ by executing a “buy-write.”¹⁹¹ FH testified that he did so on one or two occasions and was grateful for the tax benefits he received. He did not mind selling the stock on these occasions.¹⁹²

¹⁸⁵ Tr. 1885-86.

¹⁸⁶ Tr. 1891.

¹⁸⁷ Tr. 1904.

¹⁸⁸ Tr. 1908.

¹⁸⁹ Tr. 1836-37.

¹⁹⁰ Tr. 1834-35.

¹⁹¹ Tr. 1894.

¹⁹² Tr. 1916.

This is consistent with the fact that, despite claiming that he “had no intentions of ever selling or giving up” any of his UPS stock,¹⁹³ FH was willing to do so. He had sold UPS stock previously to purchase a home in West Virginia in 2005.¹⁹⁴ In addition, FH obtained a loan from Merrill that was secured with UPS stock.¹⁹⁵

In addition, Respondent knew that FH had sold UPS stock in 2002 in order to raise several hundred thousand dollars he needed at the time.¹⁹⁶ Furthermore, an ACT note dated October 31, 2003, indicates that FH had recently been willing to sell UPS stock at a price of \$52 per share.¹⁹⁷ These facts support the reasonableness of Respondent's belief that FH agreed with the recommendation that he should diversify, and that he was willing to sell UPS stock.¹⁹⁸

6. JC

JC's new account documents describe him as a retired UPS manager, married, in his late sixties, with an annual income of \$95,000 and net worth exceeding \$1 million. JC met Respondent at Respondent's father's office in 1999 and opened an account at Merrill in 2001.¹⁹⁹ JC's Option Information form identifies his investment objectives as buying and writing covered calls for speculation and income.²⁰⁰ The form indicates he had experience trading equities and

¹⁹³ Tr. 1816.

¹⁹⁴ Tr. 1866-69. FH's testimony was inconsistent on the subject of his use of UPS stock to buy property. At one point, he testified he only used UPS stock in one purchase of a house in Virginia. Tr. 1826. He admitted he testified in an arbitration hearing that he sold UPS stock to buy a Florida home as well as the Virginia home. Tr. 1859-60. When confronted with documentation of sales of UPS stock, FH changed his testimony and agreed that he had sold UPS stock in four transactions to purchase a home in West Virginia.

¹⁹⁵ After repeated questioning, FH conceded that he understood that securing the loan with UPS stock meant Merrill could take the stock in the event he defaulted on the loan. Tr. 1872-74.

¹⁹⁶ Tr. 805, 2248-49.

¹⁹⁷ RX-16, p. 004629 (10/31/03).

¹⁹⁸ Tr. 2232-33; 804-05.

¹⁹⁹ Tr. 1737-38.

²⁰⁰ CX-8a, p. 1.

options on margin with moderate frequency.²⁰¹ The documents do not reveal JC's educational background.

To prove the allegations in the Complaint relating to JC, Enforcement relied on e-mails exchanged between JC and Respondent and a transcribed recorded telephone conversation, date unknown, between JC, Respondent, and one of Respondent's partners.²⁰² In the recorded conversation, concerning covered call contracts, JC stated that he did not want to "lose" his UPS shares²⁰³ but wanted to supplement his income by \$22,000 annually with premiums from calls.²⁰⁴

When he became Respondent's customer, JC had a \$500,000 credit line at Merrill secured by UPS stock, against which he had borrowed over \$217,000.²⁰⁵

Respondent testified that he discussed diversification with JC from the beginning of their relationship. In 2001, at JC's request, Respondent prepared a handwritten six-page "analysis" or outline of proposals for diversifying.²⁰⁶ Respondent testified, and the outline corroborates, that he recommended that JC sell 10,000 shares of UPS stock to generate approximately half a million dollars, use the proceeds to pay down his Merrill loan, and "[d]iversify into [a] municipal bond portfolio."²⁰⁷

²⁰¹ *Id.*, p. 5.

²⁰² The recording is CX-18, the transcription CX-19, and the e-mails comprise CX-23. Because Respondent was unable to identify whether it was he or his partners making specific statements in the recorded conversation, the recording and transcript were received with the caveat that the words are accurately transcribed but the maker of statements to JC was either Respondent or his partner. Tr. 811-13.

²⁰³ CX-19; Tr. 814-15.

²⁰⁴ Tr. 816.

²⁰⁵ Tr. 1739-41; RX-212, RX-213, RX-214, RX-215, RX-216.

²⁰⁶ Tr. 1751-56; RX-217.

²⁰⁷ RX-217, p. 0001146.

JC was interested in diversifying, but wished to do so in stages.²⁰⁸ As JC wrote in an e-mail to Respondent, dated April 5, 2002, he wished to “protect the shares for the time being.”²⁰⁹

Respondent sent JC the same informational documents that he sent to his other customers explaining covered call writing and its risks,²¹⁰ and discussed the risks with JC.²¹¹ Respondent testified that he never told JC that he could write covered calls without the risk of having the calls assigned and being required to sell the underlying stock.²¹² He informed JC that it was impossible to predict the cost of repurchasing a call that had been exercised after the market price rose above the strike price.²¹³

Although JC did not sell his UPS stock, the evidence shows that Respondent consistently recommended that he do so.²¹⁴ For example, in an e-mail dated April 1, 2003, Respondent advised “I believe you should hold tight, max out on the call income & diversify when you are ready.”²¹⁵ An ACT note dated September 8, 2003, reflects that Respondent and JC discussed having JC diversify in 2004. According to the note, JC said he was “nervous” over being concentrated in UPS stock.²¹⁶ Shortly thereafter, Respondent recommended that JC sell calls in order to roll up the strike prices, and, as the ACT notes reflect, JC “thought it was a good idea along with diversifying.” When JC asked about “pushing the calls out in time,” Respondent

²⁰⁸ Tr. 1750.

²⁰⁹ Tr. 807-08; CX-23a, p. 10.

²¹⁰ Tr. 1764-66.

²¹¹ Respondent informed JC that he should write calls at strike prices at which he was willing to sell the shares, and warned him that if the market price of UPS stock rose above the strike price, the calls might be exercised and the underlying stock sold. Tr. 1764.

²¹² Tr. 1772.

²¹³ Tr. 1764.

²¹⁴ Tr. 1759.

²¹⁵ CX-23b, p. 8.

²¹⁶ Tr. 1760; RX-33, p. 016115 (9/8/03).

replied that he could do so, but it would simply delay the inevitable need to diversify. This conversation included consideration of selling some stock to “buy out” of the covered call position, and then diversify.²¹⁷

Respondent testified that he believed JC had a clear understanding of how covered calls worked.²¹⁸ E-mails they exchanged support Respondent. On March 19, 2002, Respondent reminded JC that a purchaser of calls might buy the stock whenever it is in the money.²¹⁹ In another e-mail, dated August 11, 2003, JC proposed a plan to “generate cash” by selling UPS at the market price with the expectation of buying it back at a lower price; he also queried Respondent on when the next dividend was due.²²⁰

Respondent also arranged for JC to access Merrill's online service so that JC could monitor his accounts. The audit trail shows that JC made frequent use of the online service for several years, from July 10, 2001, to July 3, 2005.²²¹

7. SR

SR's new account documents describe him as a married, former manager from UPS who retired at age 51 in 1998, after 31 years, with a net worth of over \$5 million.²²² His annual household income is represented at one point as being between \$300,000 and \$349,999, and at another point as being between \$125,000 and \$149,999.²²³ His risk tolerance is described consistently as moderate, his objective as growth, and his experience as including trading mutual

²¹⁷ Tr. 1761-62; RX-33, p. 016115 (11/13/03).

²¹⁸ Tr. 1792-96.

²¹⁹ RX-219.

²²⁰ RX-221.

²²¹ Tr. 1766-69; RX-218.

²²² CX-11a, pp. 1, 3-4, CX-11b, p.1, CX-11c, pp. 4-5.

²²³ CX-11b, p. 5, CX-11c, p. 5.

funds, bonds, equities, and margin trading.²²⁴ He is described in one instance as having begun investing in 1968, and in another as having begun investing in 2003.²²⁵ His Option Information form describes him as interested in writing covered calls for income, hedging and speculation.²²⁶ Because SR did not testify at the hearing, and there are no recorded conversations or e-mails with him, Enforcement concedes that there is no evidence that Respondent failed to disclose the risks of covered call writing to him.²²⁷

SR was present when Respondent provided investment advice to JC in the spring of 2001.²²⁸ Approximately two years later, he opened an account with Respondent at Merrill. At the time, SR owned approximately 60,000 shares of UPS stock against which he had borrowed approximately \$800,000. He deposited less than half of the stock into his account with Respondent.²²⁹

Respondent testified that, consistent with his practice, he recommended that SR diversify, and, as Respondent noted in an ACT entry, SR agreed "100 percent" that it was important for him to do so.²³⁰ It was SR who introduced the subject of covered call writing, saying that because his uncle, JC, was writing covered calls, he wanted to do so as well. Respondent recommended that SR use covered call writing as an exit strategy from his concentration in UPS stock, and that he keep in mind that the goal was to diversify.²³¹ Respondent warned SR of the risks of the strategy and provided him with the informational materials that he sent to his other

²²⁴ CX-11a, p. 2, CX-11c, pp. 1, 5.

²²⁵ CX-11c, p. 5, CX-11b, p. 5.

²²⁶ CX-11b, p. 1.

²²⁷ Tr. 2517.

²²⁸ Tr. 2097.

²²⁹ Tr. 2097-2100.

²³⁰ Tr. 2100; RX-26, p. 006847 (1/10/03).

²³¹ Tr. 2100-01.

customers.²³² As he did for JC, Respondent arranged for SR to access his accounts through Merrill online.²³³ For over two years, between January 29, 2003, and March 24, 2005, SR made numerous visits to the website to check his account holdings and balances.²³⁴

SR's first calls, written in March 2003, expired. Later, when the calls were in the money and nearing expiration, Respondent recommended that SR allow the calls to be sold, and provided suggestions to him about how to reinvest the proceeds in order to diversify.²³⁵

SR decided to write European-style calls after Respondent explained the alternatives. An ACT note made by Respondent reflects SR's enthusiasm upon receiving \$25,000 in premiums with his initial calls.²³⁶ Later, against Respondent's recommendation, SR wrote calls in the money. The calls were exercised in November 2003.²³⁷

Before this occurred, Respondent contacted SR to warn him of the approach of a UPS dividend date.²³⁸ Respondent recommended that if the calls were exercised SR should allow the shares to be called away.²³⁹ Although SR and his wife agreed with this recommendation and the importance of diversifying, SR decided to wait and see if the calls would be exercised. When they were, SR ultimately decided to purchase the stock back, and sell another call, because he did not wish to give up the stock at that point. Afterwards, SR continued to write covered calls, and to roll calls, financing the repurchase of calls by selling new ones.²⁴⁰ Respondent

²³² Tr. 2106-07.

²³³ Tr. 2111-12.

²³⁴ RX-226.

²³⁵ Tr. 2105.

²³⁶ Tr. 2113-15; RX-26, p. 006847 (1/29/03).

²³⁷ Tr. 2116.

²³⁸ Tr. 2117.

²³⁹ Tr. 2120.

²⁴⁰ Tr. 2123.

recommended that SR write the calls at higher strike prices, and SR followed his advice.²⁴¹

Throughout this period, ACT notes indicate that Respondent continued to recommend diversification and SR agreed that he should, although he was having trouble letting go of the stock.²⁴²

During the time he employed the strategy, SR made over \$2 million in premiums. Eventually, he allowed the stock to be called away and, at Respondent's suggestion, used the proceeds to diversify by enrolling in a Merrill investment program.²⁴³

H. Conclusion: Respondent's Recommendations Were Not Unsuitable

The Extended Hearing Panel finds that the complaining customers understood that writing covered calls obligated them to sell the underlying shares at the strike prices they set, even though they hoped that their calls would expire and that they would be able to continue to own the shares and collect premiums for selling new calls while also receiving dividends on the stock. In sum, the Extended Hearing Panel finds the testimony of the complaining customers that they were completely ignorant of how covered call options work, and of the obligation to sell stock underlying a call when it is exercised, was not credible.

Thus, based upon its review of the evidence and evaluation of the credibility of the witnesses, the Extended Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that Respondent's recommendations to the complaining customers, as alleged in Cause One of the Complaint, were unsuitable, in violation of Conduct Rules 2110, 2310 and 2860(b)(19).

²⁴¹ Tr. 2123-24.

²⁴² Tr. 2125; RX-29, p. 006771 (10/23/03, 11/13/03, 11/19/03, 12/10/03).

²⁴³ Tr. 2130; RX-227.

IV. Second Cause of Action: Advising of Risks

In order to prove the allegations in Cause Two of the Complaint, Enforcement bears the burden of proving by a preponderance of the evidence that Respondent violated Conduct Rule 2110 by failing to explain the risks of covered call writing adequately to the complaining customers, and that as a consequence, they did not fully understand the risks.²⁴⁴

The Extended Hearing Panel finds that Enforcement did not meet this burden. The evidence, as discussed in detail above, does not support the claim that Respondent failed to explain the risks associated with writing covered call options contracts, or that the complaining customers did not fully understand the risks associated with rolling covered calls forward when they were in the money, and deep in the money. The evidence does not support the complaining customers' claims that Respondent improperly told them that there were no risks associated with covered call writing.

V. Third Cause of Action: False and Misleading Communications

Rule 2210(d)(1)(A) requires that communications with the public be "fair and balanced," and not omit any material fact whose omission might cause the communications to mislead. Rule 2210(d)(1)(B) prohibits making any "false, exaggerated, unwarranted or misleading" claims in any communication with the public. It also prohibits distributing any public communication knowing or with reason to know that the communication contains "any untrue statement of a

²⁴⁴ In its Pre-Hearing and Post-Hearing Briefs, in its legal analysis of Cause Two of the Complaint, Enforcement cites one case, *Dep't of Enforcement v. Davenport*, 2002 NASD Discip. LEXIS 29 (Mar. 4, 2002). *Davenport* is a hearing panel decision that concerns misrepresentations made by a broker to his firm about loans made to him by some of his customers, and does not address the obligation of a registered representative to apprise customers of risks. Advising customers of risks inherent in a recommended investment is important, but the responsibility of a broker to determine the suitability of a recommendation involves more than just disclosure of risks. *Dep't of Enforcement v. Chase*, 2001 NASD Discip. LEXIS 30, *16-17 (NAC Aug. 15, 2001), citing *Patrick G. Keel*, 51 S.E.C. 282, 284-86 (1993). Because the Extended Hearing Panel concludes that Enforcement failed to prove its allegations in Cause Two by a preponderance of the evidence, it is unnecessary to determine whether Respondent's alleged failure to advise customers of the risks in the context of this case constitutes a viable cause of action separate and apart from Cause One's allegations of violations of the suitability rule.

material fact or is otherwise false or misleading.” Finally, Rule 2220(d)(1) imposes these requirements upon public communications relating to options.

The Third Cause of Action alleges that Respondent violated these rules when he sent JW a single summary of his account in late 2003, and sent AW several monthly summaries of his and his wife's accounts between September 2002 and April 2003. The summaries were allegedly “false, exaggerated, unwarranted or misleading regarding the apparent income AW and JW were generating from the covered calls written in their accounts.”²⁴⁵ The Complaint asserts that Respondent's use of the term “income” instead of “premiums” in the summaries was misleading because what Respondent described as “income” was in fact, according to the Complaint, “actually just ‘premiums’ (cash flow)” and “not *realized* ‘income.’”²⁴⁶ To create documents that misrepresent the facts about a customer's account, and mislead the customer, is “the antithesis of a registered representative's [duty to uphold] high standards of commercial honor,” and violates Rule 2110.²⁴⁷

Respondent prepared the summaries for AW after AW complained that he found the Merrill monthly account statements difficult to understand and asked Respondent to “come up with something” he could more easily comprehend. Respondent said he would take information from the Merrill monthly statements, which AW would continue to receive, and put it in a form that would be easier to read.²⁴⁸ Respondent's purpose was to aid AW in understanding the

²⁴⁵ Complaint, ¶¶ 69, 89.

²⁴⁶ Complaint, ¶ 69 (emphasis in original).

²⁴⁷ *Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *51 (NAC May 10, 2010), quoting *Dep't of Enforcement v. Abbondante*, No. C10020090, 2005 NASD Discip. LEXIS 43, at *31-32 (NAC Apr. 5, 2005), *aff'd*, Exch. Act Rel. No. 53066, 2006 SEC LEXIS 23 (Jan. 23, 2006), *petition for review denied*, 209 Fed. Appx. 6 (2d Cir. 2006).

²⁴⁸ Tr. 628-29.

Merrill monthly statements.²⁴⁹ For the format, Respondent used templates for a power-point presentation maintained by his working group at Merrill.²⁵⁰ Respondent testified that he sent each summary to AW with a complete Merrill monthly statement.²⁵¹

Similarly, Respondent prepared JW's summary in response to JW's request for assistance. In an e-mail dated November 26, 2003, JW asked Respondent to provide information to help him keep track of the premiums generated by his covered calls.²⁵² In response, Respondent prepared a single summary, again formatted using a Merrill template, depicting the premiums received by JW from covered calls with expiration dates of January and April 2005.²⁵³ JW testified that when he received the summary, he was "frustrated" because the summary was "simplistic" and "elementary," lacking the detail he had expected.²⁵⁴

Enforcement argues that these summary statements were misleading in part because they were incomplete. Enforcement's staff investigator Catherine Siewick testified that the summary statements did not reflect "risks," and did not explain how the estimated income from covered calls was calculated.²⁵⁵ Allaire, Enforcement's expert, testified that the summaries were misleading because they did not include the potential liability of sold calls, or short call positions.²⁵⁶

²⁴⁹ Tr. 2253-54.

²⁵⁰ Tr. 987-89.

²⁵¹ Tr. 2251-53.

²⁵² Tr. 1080-81; CX-25, p. 1. JW testified that he asked Respondent for help because the Merrill statements were confusing, he wanted to know how much he was making from the calls and also wanted to find out the amount of Respondent's commissions. Tr. 465-66.

²⁵³ Tr. 1002-03; CX-22.

²⁵⁴ Tr. 466.

²⁵⁵ Tr. 1161-63.

²⁵⁶ Tr. 1279-81.

However, Respondent sent the summaries to supplement, not replace, regular monthly Merrill account statements, and knew that AW and JW received their complete monthly statements from Merrill, which detailed their realized losses.²⁵⁷ In addition, with the summaries he sent to AW, Respondent enclosed the most recently available Merrill monthly statements.²⁵⁸ Respondent made explanatory notations on some of these Merrill statements. For example, in the September summary he sent to AW, Respondent circled the figures representing year-to-date realized and unrealized losses on the Merrill statement and wrote: “these refer to the rolling of the calls.”²⁵⁹ Thus, Respondent did not attempt to divert AW’s attention from his losses, but directed his attention to them.

As for his use of the term “income,” Respondent testified that in his experience, the terms “income” and “premium” in the context of covered calls are interchangeable.²⁶⁰ The parties’ experts agreed with Respondent.²⁶¹ Indeed, Allaire testified that it is common for brokers to use the term “income” when discussing premiums generated by covered calls with clients, and conceded that he has probably used “income” when referring to premiums generated by covered calls in his published writings.²⁶²

To prevail, Enforcement must prove by a preponderance of the evidence that the summaries Respondent sent to JW and AW contained untrue statements, or exaggerated or unwarranted claims, rendering them false or misleading regarding the income being generated by

²⁵⁷ Tr. 2285-86.

²⁵⁸ Tr. 986, 994, 2253-54.

²⁵⁹ CX-21, p. 40.

²⁶⁰ Tr. 991.

²⁶¹ Tr. 1408.

²⁶² Tr. 1368-70. Allaire testified that the use of the word income for premiums derived from the tax code of 1973, which stated that any option premium received would be treated as ordinary income. Thenceforth, the term income has been used for premiums in “every option book, every article that talks about covered writing.” Tr. 1199.

the covered calls in their accounts. Enforcement relies on *Dep't of Enforcement v. Dunbar*²⁶³ to support its argument that Respondent's summaries violated Rule 2110. *Dunbar*, however, is factually distinguishable. First, the respondent in *Dunbar* provided customers misleading summaries in a suspicious context, when the customers' accounts began to deteriorate dramatically.²⁶⁴ Here, the context in which the summaries were prepared was not suspicious. In *Dunbar*, the respondent created account summaries that grossly misrepresented cash balances in the accounts, failed to disclose large margin debit balances, and failed to disclose substantial positions that the respondent had established for the customers in various securities.²⁶⁵ Here, the summaries made no such fundamental misrepresentations and the customers were provided with their complete Merrill statements. In *Dunbar*, the circumstances created doubt about the respondent's good faith.²⁶⁶ Here, the Extended Hearing Panel finds that the circumstances support Respondent's good faith.

Another more recent decision, *Dep't of Enforcement v. Cody*,²⁶⁷ is instructive. In *Cody*, the respondent prepared improper account summaries showing customers holding securities they had not purchased, or in quantities they did not possess. In addition, the summaries contained false information as to why certain securities were sold. The customers who received the summaries believed they were comprehensive descriptions of their accounts.²⁶⁸ In this case, Respondent's summaries did not contain such fabricated information and, as noted above, JW and AW understood the summaries were *not* comprehensive account statements of their

²⁶³ No. C07050050, 2008 FINRA Discip. LEXIS 18 (NAC May 20, 2008).

²⁶⁴ *Dunbar*, *supra* at *18-19.

²⁶⁵ *Dunbar*, *supra* at *16-17.

²⁶⁶ *Dunbar*, *supra* at *18.

²⁶⁷ No. 2005003188901, 2010 FINRA Discip. LEXIS 8 (NAC May 10, 2010).

²⁶⁸ *Cody*, *supra* at *52-53

This Decision has been published by FINRA’s Office of Hearing Officers and should be cited as OHO Redacted Decision 2007009461301.

accounts, but represented Respondent’s effort to respond to their requests for help in interpreting their monthly statements.

The Extended Hearing Panel finds, therefore, that Enforcement failed to prove by a preponderance of the evidence that the summaries were false, exaggerated, unwarranted or misleading regarding the apparent income AW and JW were receiving from the covered calls written in their accounts. The Extended Hearing Panel finds there is no evidence that Respondent intended to mislead JW or AW. Finally, Enforcement failed to establish by a preponderance of the evidence its central assertion on this point, that Respondent’s use of the term “income” rather than “premiums,” in reference to the cash flow generated by selling covered calls, was false or misleading.

VI. Order

For the reasons set forth above, the Extended Hearing Panel dismisses the Complaint against Respondent.²⁶⁹

EXTENDED HEARING PANEL.

By: Matthew Campbell
Hearing Officer

²⁶⁹ The Extended Hearing Panel has considered and rejects without discussion all other arguments of the parties.