BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Alan Jay Davidofsky Delray Beach, FL, Respondent.	DECISION Complaint No. 2008015934801 Dated: April 26, 2013

Respondent engaged in unauthorized trading, excessive trading, and churning in a customer's individual retirement account. Held, findings affirmed and sanctions affirmed.

Appearances

For the Complainant: Sarah B. Belter, Esq. and Leo F. Orenstein, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Pro Se

Decision

Alan Jay Davidofsky appeals a Hearing Panel decision issued on March 30, 2012. The Hearing Panel found that Davidofsky engaged in unauthorized trading, excessive trading, and churning in a customer's individual retirement account. The Hearing Panel barred Davidofsky for the unauthorized trading, imposed a separate bar for the excessive trading and churning, and ordered Davidofsky to pay a fine of $11,741.78 as disgorgement of the financial benefit from his misconduct. After an independent review of the record, we affirm the Hearing Panel's findings and sanctions.

I. Factual Background

A. Davidofsky

Davidofsky entered the industry in June 1988, and remained registered with FINRA continuously until the termination of his most recent registration in February 2011. During the period relevant to the conduct in this case, December 2007 through October 2008, Davidofsky was associated with Oppenheimer & Co., Inc.

B. Davidofsky Joins Oppenheimer and Experiences Financial Difficulties

In November 2004, Davidofsky joined Oppenheimer as a general securities representative. When he joined the firm, he brought a book of business with him. In return, Oppenheimer gave Davidofsky an upfront signing bonus structured as a five-year forgivable loan. Under the terms of the loan agreement, Oppenheimer forgave a portion of the loan each month that he remained with the firm. If Davidofsky left Oppenheimer for any reason before the end of the five-year term, the firm required him to repay the balance of the loan.

Davidofsky did relatively well during his first two years at Oppenheimer. By 2006, however, he had lost two of his largest accounts and began to experience financial difficulties. Davidofsky's commissions declined and his financial difficulties continued throughout 2007 and 2008. In April 2008, Davidofsky contemplated filing for bankruptcy. Davidofsky's filing of bankruptcy, however, was contingent upon Oppenheimer's approval of the plan to restructure his debt. The firm agreed to approve the bankruptcy plan and continue Davidofsky's employment, on the condition that he maintain certain levels of commissions, continue his compliance with Oppenheimer's loan agreement, and did not attempt to discharge Oppenheimer's loan as part of the bankruptcy proceedings. In September 2008, Davidofsky filed for bankruptcy.[1] The bankruptcy court discharged Davidofsky's debt in February 2009.

C. Davidofsky Manages JL's Traditional Individual Retirement Account

In the midst of handling these personal financial matters, Davidofsky gained a new account at Oppenheimer, JL's traditional individual retirement account.[2] Davidofsky began managing JL's individual retirement account in March 2007, after her former Oppenheimer representative, Charles Shalmi, could no longer handle the account.[3]

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1 In September 2008, Oppenheimer reduced Davidofsky's salary because his production did not meet the goal that Oppenheimer had set for him at the beginning of the year. During his on-the-record testimony, Davidofsky testified that Oppenheimer warned him to "get [his] numbers up."

2 JL testified at the hearing. JL maintained individual retirement accounts at Oppenheimer, DWS Scudder Investments, Inc., Fidelity Investments Institutional Services Company, Inc., and Charles Schwab & Co., Inc. In 2007 and 2008, JL's Roth and traditional individual retirement accounts at DWS Scudder were worth approximately $34,000. Her Roth and traditional individual retirement accounts at Fidelity Investments were worth approximately $13,000, and her traditional individual retirement account with Charles Schwab was worth approximately $6,000. JL also had four other accounts at Oppenheimer, in addition to the traditional individual retirement account that is at issue here. JL maintained a joint securities account with her mother and sister, two securities accounts for the benefit of her mother, and a regular securities account for herself. It is only JL's traditional individual retirement account at Oppenheimer that is the subject of this proceeding.

3 Shalmi testified at the hearing. He stated that he recommended that Davidofsky handle JL's individual retirement account because he and Davidofsky were friends, and he thought that Davidofsky was qualified to handle the account. Although Davidofsky managed JL's traditional individual retirement account, Shalmi continued handling JL's other four securities accounts at Oppenheimer.

1. JL's Background and Investment Experience

JL lives in Massachusetts.[4] She is a college graduate with a degree in mass communications. JL develops and produces multimedia training and marketing materials for corporations. In 2003, she also began providing educational consulting services to her sister's company.

JL described her investment experience as limited. She testified that she started investing in the 1970s, with a small account at DWS Scudder. JL explained that she invested in growth, income, and mutual funds, which she characterized as "self-managed" investments. She also stated that she traded stocks infrequently, and that she had purchased "two stocks in [her entire] life."

JL's account information form at Oppenheimer identified her as 57 years old, single, with no dependents, and 10 years of investment experience. The form noted that JL had been self-employed for 10 years and earned an annual income of $50,000. The form stated that JL's total net worth was approximately $300,000, and that her liquid net worth, "exclusive of home, auto, etc.," was $10,000.

2. Davidofsky Revises the Trading Strategy for JL's Account

Prior to the period at issue in this case, there was minimal activity in JL's individual retirement account. The account maintained an average monthly balance of $127,000 and held positions in four closed-end mutual funds, three open-end mutual funds, and two corporate bonds. JL's account contained only one position in an individual stock. JL owned 114 shares of Delta Airlines common stock.

After Davidofsky gained responsibility for JL's account, he reviewed the account activity and spoke to Shalmi about JL.[5] Davidofsky's review led him to conclude that JL's conservative investment objectives did not match the holdings in her account, and that JL "was completely wrong [about] her stated [investment] objectives."[6] Davidofsky communicated his findings to JL during their first conversation.[7]

In line with these findings, Davidofsky began implementing a revised trading strategy for JL's individual retirement account. Under this revised strategy, Davidofsky tried to "take advantage

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[4] Shalmi voluntarily permitted his Massachusetts securities license to lapse and could no longer transact securities business in the state.

[5] Davidofsky testified that JL requested the portfolio review.

[6] When Davidofsky began managing JL's individual retirement account, JL's account information form at Oppenheimer reflected that JL's investment objectives were "current income (conservative)" and "capital appreciation (conservative)." At the hearing, JL testified that conservative current income and capital appreciation were her investment objectives throughout the time she had the individual retirement account at Oppenheimer.

[7] JL confirmed Davidofsky's account of their initial conversation.

of the turns in the market." Specifically, he looked for "brand name" companies that were currently trading at 25 to 40 percent below their highest per-share price. Davidofsky reasoned, "if [these stocks are] all being recommended at, say, $50.00 a share by all the analysts on Wall Street and at $30.00 a share the analysts are still recommending them, that's a bargain."

Davidofsky also turned to preferred stocks to increase short-term returns. He noted that many preferred stocks, particularly those from financial and mortgage companies, presented opportunities for gains because they "were trading at extraordinary yields and discounts to their coupon." Davidofsky explained that if he "could buy a preferred stock at $20.00, on or around the time they are going to declare a dividend, which is every three months, [he had] the chance of collecting a dividend and holding onto the stock and selling it for capital appreciation." Davidofsky characterized this as a "win-win scenario."

Davidofsky testified that he told JL about his revised trading strategy, and that she said that "it was a little bit riskier than what she was used to, but she was not against the idea." JL, however, did not authorize Davidofsky to employ the revised, riskier strategy in her individual retirement account. Despite this fact, Davidofsky began implementing the revised trading strategy in JL's account in December 2007.[8]

3. Davidofsky Implements the Revised Trading Strategy and Drastically Increases the Frequency of Trading in JL's Account

With the implementation of the revised trading strategy in December 2007, the frequency and tenor of Davidofsky's trading in JL's account also increased drastically. Between December 2007 and October 2008, Davidofsky liquidated JL's then-current holdings and effected 104 transactions in 38 different securities. He effected these trades on 61 different days during the relevant period and often made multiple trades in a single day. Davidofsky's purchases totaled approximately $760,000, and his total transactions amounted to more than $1.4 million.[9]

Davidofsky's activity in JL's account also evidenced a strategy of "in-and-out trading."[10] For example, Davidofsky purchased and sold 4,350 shares of Evergreen Solar, Inc. in eight transactions between January and July 2008. Davidofsky also purchased and sold 3,050 shares of

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[8] At the hearing, Davidofsky conceded that it was his "poorly executed trading strategy" that caused the losses in JL's account. Davidofsky testified that the trading strategy and the market conditions at the time necessitated "the recommended selling," because timed selling was the critical tool, which he employed to limit his customers' losses. Davidofsky surmised that if he did not continue selling the shares in JL's account, JL "would have been even worse off sooner rather than later."

[9] In the months prior to Davidofsky's management of JL's individual retirement account, JL's total purchases in the account totaled approximately $66,000.

[10] "In-and-out trading" is the sale of all or part of the securities in an account and reinvestment of the sales proceeds in other securities, followed by the sale of the newly acquired securities. *See Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at *47 n.39 (May 27, 2011), *aff'd*, 2012 U.S. App. LEXIS 18914, at *1 (1st Cir. 2012).

Agfeed Industries, Inc. in 10 transactions between April and September 2008. In several instances, Davidofsky purchased and sold securities in as few as two days and often held securities for less than a few weeks.[11]

Davidofsky testified that he focused his revised trading strategy on the volatile market conditions at the time, not JL's financial needs and investment objectives. Indeed, he conceded that, in a less volatile market, his trading strategy would not have been appropriate for JL, and that it was the difficult market conditions that forced him to employ the riskier trading strategy.

4. JL's Investment Objectives Are Changed

As the frequency and tenor of the trading activity in JL's account continued to intensify, JL's account information form was amended to change her investment objectives. In June 2008, a sales assistant at Oppenheimer updated JL's account information form. The sales assistant changed JL's investment objectives to "current income (aggressive)" and "capital appreciation (aggressive)." The sales assistant also updated the form to acknowledge that JL had approved the use of "short-term trading" in her account. JL testified that she did not initiate or approve any of these changes.[12]

Davidofsky and Kathleen Saia, Oppenheimer's Administrative Branch Manager for the Boca Raton office, each testified at the hearing about what may have prompted the changes to JL's investment objectives.[13] Davidofsky was unable to recall what specifically prompted the changes to JL's account information form, but he explained how such changes usually occurred. Davidofsky stated that Saia typically approached him when there were questions about a customer's account activity and investment objectives. Davidofsky recalled that JL's then-current holdings were not reflective of a conservative portfolio and surmised that he and Saia discussed JL's account. He also stated that it was his practice, after having this type of conversation with Saia, to contact the customer, discuss the customer's holdings and goals, and obtain the customer's approval to update the account information form to more accurately reflect the customer's account activity and investment objectives. Davidofsky assumed that is what occurred in this case and testified that JL "never said a word to [him] about [the changes to her investment objectives]."

Saia confirmed that it was her practice to speak with registered representatives whose customer's account activity may not accurately reflect the customer's investment objectives. Saia explained that, when these instances occurred, she generally recommended that the registered

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[11] For example, Davidofsky purchased 1,100 shares of Canadian Solar, Inc.; 3,500 shares of Pacific Ethanol Inc.; and 750 shares of Lehman Brothers Holdings, Inc. on December 5, 2007; January 28, 2008; and August 13, 2008, respectively. Davidofsky sold the purchased shares of each company two days later.

[12] Oppenheimer sent JL notice of the changes to her account information form with her account statement for June 2008. JL testified that she did not open her statements for the period at issue and did not see Oppenheimer's notice of the changes to her investment objectives.

[13] Davidofsky, as the registered representative responsible for JL's account, provided first-level approval of account changes. Saia, as the Administrative Branch Manager, provided the second-level approval and processed the account changes.

representative contact the customer to obtain approval to change the investment objectives. Saia also recalled speaking to Davidofsky about JL's account. Saia's testimony, however, suggests that JL did not request or approve the changes to her investment objectives in this case.

Saia testified that JL's individual retirement account appeared in an account review exception report in June 2008. Saia could not recall what activity in JL's account triggered creation of the exception report. Accordingly, she could not determine whether she discussed JL's account with Davidofsky because she had questions about JL's account activity and investment objectives, or if she discussed the account with him because he had initiated and approved changes to JL's investment objectives.

Although it is unclear what caused JL's account to generate the exception report, Saia called JL when she received the exception report in June 2008.[14] Saia reached JL, but JL said that she did not have time to talk and would return Saia's call at a later date. JL did not return Saia's call in June or July, and Saia tried to reach JL again in August 2008. This time, Saia left a voice message for JL. JL did not return Saia's call and did not approve the changes to her investment objectives.

5. JL Discovers the Activity in Her Account

JL reviewed her account statements after a steep market decline in September 2008.[15] JL testified that some friends had told her of the losses they had sustained in the securities markets, and she became curious about the status of her own securities accounts. JL discovered the activity in her account in October 2008, as she reviewed statements from the prior months. JL immediately emailed Davidofsky after she reviewed the statements and told him that she would call him later that day to discuss her findings.[16] She also filed a complaint with Oppenheimer, which initiated an internal investigation and review of JL's account.

During the 10-month period that Davidofsky implemented his revised trading strategy, JL's individual retirement account lost approximately 90 percent of its value, which equated to an account balance decline of approximately $108,000.[17] The annualized turnover ratio was 10.89, and

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[14] Saia approved the changes to JL's account information form and processed the form in June 2008.

[15] JL testified that she did not open her Oppenheimer account statements and confirmations as they arrived because she did not feel she needed to do so. JL explained that she thought that the Oppenheimer mailings related to the activity in the joint account with her mother and sister because she had made a few trades in that account based on Shalmi's recommendations. She also noted that she thought that a review of her individual retirement account was unnecessary because she intended to employ a buy-and-hold strategy with mutual funds in the account. Finally, JL testified that she generally rejected the purchase of individual stocks for the individual retirement account because she thought that stocks had gone as high as they were going to go, and consequently, she did not believe there was any activity in the account that needed her attention.

[16] JL noted that she did not recognize many of the securities in her account.

[17] Oppenheimer entered into a settlement agreement with JL and paid her $100,000 "as a refund for account losses."

the annualized cost-to-equity ratio was 44.86 percent. JL paid over $31,000 in commissions to Oppenheimer, of which $11,741.78 went directly to Davidofsky.[18]

6. Oppenheimer's Telephone Records

In November 2008, JL called Saia to complain about the activity in her account. Saia initiated an investigation of JL's complaint. As part of the investigation, Saia requested that Oppenheimer's telecommunications department search for records of all telephone calls between JL and the Boca Raton office for the period of November 2007 through November 2008.[19]

Kevin Blunnie, Oppenheimer's Senior Director of Communications who completed the search, testified at the hearing. Blunnie explained that, after he conducted two searches, Oppenheimer uncovered a total of 37 calls.[20]

II. Procedural Background

In November 2008, Oppenheimer terminated Davidofsky for the conduct at issue. In conjunction with Davidofsky's discharge, the firm filed a Uniform Termination Notice for Securities Industry Registration ("Form U5"). Enforcement initiated an investigation of the circumstances surrounding Davidofsky's discharge upon receipt of the Form U5.

Enforcement filed a three-cause complaint in February 2011. The first cause of action alleged that Davidofsky engaged in unauthorized trading, in violation of NASD Rule 2110 and NASD Interpretative Material ("IM") 2310-2. The second cause of action alleged that Davidofsky excessively traded JL's account, in violation of NASD Rules 2110, 2120, 2310, and IM-2310-2. The third cause of action alleged that Davidofsky churned JL's account, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and NASD Rules 2110 and 2120.[21]

A two-day hearing took place in Boca Raton in December 2011. Six witnesses testified at the hearing, including Davidofsky. The Hearing Panel issued its decision in March 2012. This appeal followed.

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[18] This amount represented 18 percent of Davidofsky's total commissions for 2008.

[19] The telephone records began with calls on November 12, 2007, and ended with calls on October 10, 2008. The trading that is at issue began on December 3, 2007, and ended on September 30, 2008.

[20] In May 2008, Oppenheimer placed Davidofsky on heightened supervision and required that Davidofsky document every customer conversation in Insight Notes, the firm's database management system. Davidofsky's Insight Notes for JL's individual retirement account began on April 14, 2008, shortly before Oppenheimer required him to maintain the notes.

[21] The conduct rules that apply in this case are those that existed at the time of the conduct at issue.

III. Discussion

A. Davidofsky Effected Unauthorized Trades in JL's Account

The Hearing Panel found that Davidofsky violated NASD Rule 2110 and IM-2310-2 because he effected 82 unauthorized trades in JL's individual retirement account between December 2007 and October 2008.[22] We affirm the Hearing Panel's findings.

NASD Rule 2110 requires that FINRA members "observe high standards of commercial honor and just and equitable principles of trade."[23] Unauthorized trading in a customer's account is a fundamental betrayal of the duty owed by a salesman to his customers and constitutes a serious violation of NASD Rule 2110.[24] *See Wanda P. Sears*, Exchange Act Release No. 58075, 2008 SEC LEXIS 1521, at *6 (July 1, 2008) (stating that associated persons are responsible for obtaining their customer's consent prior to purchasing a security for the customer's account). Indeed, such misconduct goes "to the heart of the trustworthiness of a securities professional." *Id.*

A preponderance of the evidence establishes that Davidofsky engaged in the unauthorized trading that is at issue. *See generally David M. Levine*, Exchange Act Release No. 48760, 2003 SEC LEXIS 2678, at *73 n.42 (Nov. 7, 2003) (holding that preponderance of the evidence is the standard of proof in a self-regulatory organization's disciplinary proceedings). As an initial matter, JL testified that she did not authorize Davidofsky to use discretionary authority in the individual retirement account and did not approve the 82 trades that he effected in the account between December 2007 and October 2008. JL stated that she spoke to Davidofsky approximately six times during the entire period that he managed the account, and that he discussed investments with her only during three or four of those calls. JL acknowledged that she authorized transactions on the three or four occasions that she and Davidofsky discussed investment opportunities.

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[22] Davidofsky effected 104 trades in JL's individual retirement account between December 2007 and October 2008. Of these transactions, Enforcement alleged that 90 trades were unauthorized, excluding 14 transactions for which Davidofsky received no commission. In rendering its decision, the Hearing Panel excluded an additional eight trades based on the updated telephone records received from Oppenheimer in December 2011. The Hearing Panel found that eight of the 37 calls corresponded with the dates of trades in JL's account. The Hearing Panel noted that, while there is no evidence of the substance of Davidofsky's and JL's discussions during the eight calls, there is the possibility that JL could have approved the transactions at issue. On appeal, we find that receipt of a commission should have no bearing on the determination of whether a trade is unauthorized. We, however, conclude that the record does not contain sufficient evidence to review these 14 trades to determine whether they were unauthorized. We therefore limit our review to the issue of whether Davidofsky effected 82 unauthorized trades in JL's individual retirement account.

[23] NASD Rule 0115 makes all FINRA rules, including NASD Rule 2110, applicable to both FINRA firms and all persons associated with FINRA firms.

[24] NASD IM-2310-2(b)(4)(iii) , which discusses fair dealing with customers, reinforces this premise and explains that unauthorized transactions constitute fraudulent conduct for which FINRA may initiate disciplinary proceedings and impose sanctions.

Davidofsky flatly contradicted JL's testimony and testified that JL authorized all the trades at issue. The Hearing Panel, however, concluded that JL was a credible witness, and we have no basis to overturn the Hearing Panel's credibility determination.[25] *See John Montelbano,* 56 S.E.C. 76, 89 (2003) ("[C]redibility determinations of an initial fact-finder, which are based on hearing the witnesses' testimony and observing their demeanor, are entitled to considerable weight and deference and can be overcome only where the record contains substantial evidence for doing so.").

The documentary evidence in the record also corroborates JL's testimony and supports the conclusion that Davidofsky's trading in JL's account was unauthorized. Oppenheimer's telephone records, for example, disclose that only eight of the 37 calls between JL and Oppenheimer's Boca Raton office corresponded to trading dates in JL's individual retirement account. *See, e.g., Dep't of Enforcement v. Haq*, Complaint No. ELI2004026701, 2009 FINRA Discip. LEXIS 3, at *18-19 (FINRA NAC Apr. 6, 2009) (finding that the firm's telephone records suggested that the respondent had engaged in unauthorized trading). With one exception, Davidofsky claimed that he always called JL from his office telephone, and during the hearing, confirmed the telephone numbers that Oppenheimer included in its search for telephone records.

Relying on his Insight Notes, Davidofsky questions the reliability of Oppenheimer's telephone records.[26] After a review of the evidence presented, we are satisfied with Oppenheimer's search for the telephone records and conclude that the records are reliable evidence of the unauthorized trading that occurred in this case. The record of calls was generally congruent with JL's testimony that she spoke to Davidofsky approximately six times during the relevant period.

The telephone records also accurately reflected Shalmi's Insight Notes and trade records concerning his transactions with JL. There was no such correlation between the telephone records and Davidofsky's Insight Notes and trade records. A comparison of Oppenheimer's telephone records and Shalmi's Insight Notes showed that eight out of nine transactions were matched to a telephone call. This is a strong indication of accuracy, which leads us to conclude that Oppenheimer's telephone records are reliable. In addition, while Davidofsky questioned the accuracy of Oppenheimer's telephone records, he failed to offer any explanation for the lack of telephone records for the 82 trades, and could not explain why there were no telephone records for the entire months of January, March, and July 2008, months in which he had engaged in significant trading in JL's account.

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[25] On appeal, Davidofsky points to JL's holdings in the individual retirement account prior to his handling of the account, and to the holdings in her other securities and retirement accounts, to demonstrate that JL was not a conservative investor and suggest that JL authorized his trading. We note, first, that the activity in JL's other accounts is irrelevant to whether JL authorized the trades in her individual retirement account. In addition, the record supports that JL was not an active trader. JL testified that she had purchased only two individual stocks in her life, and the record supports this testimony. There is nothing in the record or JL's pattern of investing to suggest that JL approved 82 trades in 10 months.

[26] Davidofsky's Insight Notes concerning his conversations with JL corresponded with the trades that Davidofsky effected in JL's account.

The record in this case establishes that Davidofsky effected 82 unauthorized trades in JL's individual retirement account, and consequently, violated NASD Rule 2110 and NASD IM-2310-2.

B. Davidofsky Excessively Traded and Churned JL's Account

The Hearing Panel found that Davidofsky violated NASD Rules 2110, 2310, and NASD IM-2310-2 because he excessively traded JL's individual retirement account. In related findings, the Hearing Panel also concluded that the volume of Davidofsky's trading in JL's account constituted churning, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Rules 2110 and 2120. We affirm the Hearing Panel's findings.

NASD Rule 2310(a) provides that "[i]n recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Among the obligations under such suitability rules is "quantitative suitability," which focuses on "whether the number of transactions within a given timeframe is suitable in light of the customer's financial circumstances and investment objectives." *Dep't of Enforcement v. Medeck*, Complaint No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *32 (FINRA NAC July 30, 2009).[27]

To demonstrate excessive trading, or quantitative unsuitability, requires proof of two elements. The first element is "broker control over the account in question." *Id.* at *34. The second element is "excessive trading activity inconsistent with the customer's financial circumstances and investment objectives."[28] *Id.* Excessive trading is closely related to, but distinct from, churning. Churning exists where excessive trading involves fraud. *Id.* Thus, to prove that Davidofsky's excessive trading amounts to churning, a third element, scienter, must be shown. *Id.* As explained below, the record amply shows that Davidofsky controlled JL's account, there was excessive trading activity inconsistent with JL's financial circumstances and investment objectives, and that Davidofsky excessively traded the accounts with scienter, and consequently, churned JL's account.

[27] Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Rule 2120 prohibit associated persons from using manipulative, deceptive, or other fraudulent devices or contrivances in connection with the purchase or sale of any security. NASD IM-2310-2(b)(2) explains that excessive trading and churning "clearly violate [the] responsibility for fair dealing" with customers. Finally, a violation of any Commission or FINRA rule constitutes conduct inconsistent with the high standards of commercial honor and just and equitable principles of trade, and accordingly, violates NASD Rule 2110. *Dennis Todd Lloyd Gordon*, Exchange Act Release No. 57655, 2008 SEC LEXIS 819, at *4 n.3 (Apr. 11, 2008).

[28] Any violation of the suitability rule also requires proof that there was a "recommendation." When a registered representative engages in unauthorized trading, as Davidofsky did, such trades are considered implicitly recommended for purposes of the suitability rule. *See Medeck*, 2009 FINRA Discip. LEXIS 7, at *35 n.14.

1. Control

A broker exercises control over an account if "the broker has either discretionary authority or de facto control over the account." *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34. While JL never gave Davidofsky discretion, either verbally or in writing, to trade her account, Davidofsky nevertheless had de facto control over JL's account in this case. Without JL's knowledge or approval, Davidofsky traded in JL's account as if he had discretion, purchasing and selling shares indiscriminately until JL discovered, questioned, and complained of the activity to Oppenheimer. These circumstances demonstrate Davidofsky's de facto control of JL's account. *See Sandra K. Simpson*, 55 S.E.C. 766, 796 (2002) (explaining that de facto control exists if a customer is incapable of controlling the account because of unauthorized trading); *see also Olde Discount Corp.*, 53 S.E.C. 803, 832 (1998) (stating that, "unauthorized trading presents clear evidence of control").

2. Excessive Activity

Having established the element of control, we next turn to whether there was excessive trading activity inconsistent with JL's financial circumstances and investment objectives. The "assessment of the level of trading . . . does not rest on any magical per annum percentage, however calculated." *Gerald E. Donnelly*, 52 S.E.C. 600, 603 (1996). Nevertheless, "factors such as turnover rate, cost-to-equity ratio, and use of 'in-and-out' trading in an account may provide a basis for a finding of excessive trading." *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34-35.

The record in this case demonstrates that JL sought to invest with a conservative amount of risk. JL's account information form at Oppenheimer identified JL as 57 years old, single, with an annual income of $50,000. The form stated that JL's total net worth was approximately $300,000, and that her liquid net worth was $10,000. JL's individual retirement account maintained an average monthly balance of $127,000.

The tempo and quantity of Davidofsky's trading in JL's account was entirely inconsistent with JL's financial circumstances and investment objectives. Prior to Davidofsky's management of JL's individual retirement account, the account had minimal activity. When Davidofsky took over management of JL's account, however, the volume of trading in the account changed dramatically. Over a period of 10 months, Davidofsky effected 104 transactions in 38 different securities. He effected these trades on 61 different days during the relevant period, often made multiple trades in a single day, and engaged in in-and-out trading of numerous stocks.

Davidofsky's trading yielded an annualized turnover ratio of 10.89,[29] and an annualized cost-to-equity ratio of 44.86 percent,[30] both of which are substantially above the levels that have

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29 "Turnover rates between three and five have triggered liability for excessive trading, and it has been generally recognized that an annual turnover rate of greater than six evidences excessive trading." *Jack H. Stein*, 56 S.E.C. 108, 118 (2003); *see also Peter C. Bucchieri*, 52 S.E.C. 800, 805 (1996) ("While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading.").

30 A cost-to-equity ratio in excess of 20 percent indicates excessive trading. *See Rafael Pinchas*, 54 S.E.C. 331, 340 (1999); *Bucchieri*, 52 S.E.C. at 801-03 (finding excessive trading

[Footnote continued on next page]

supported findings of excessive trading in other cases. The record demonstrates that Davidofsky excessively traded JL's account and violated NASD Rules 2110, 2310, and NASD IM-2310-2.[31]

3. Scienter

To find that Davidofsky's excessive trading also amounted to churning requires us to find that he acted with scienter. *See Dep't of Enforcement v. Murphy*, Complaint No. 2005003610701, 2011 FINRA Discip. LEXIS 42, at *54-58 (FINRA NAC Oct. 20, 2011), *appeal docketed*, SEC Admin. Proceeding No. 3-13055 (Oct. 28, 2011). "Scienter requires proof that a respondent intended to deceive, manipulate, or defraud, or 'acted with severe recklessness involving an extreme departure from the standards of ordinary care.'" *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34 (quoting *Dep't of Enforcement v. Reynolds*, Complaint No. CAF990018, 2001 NASD Discip. LEXIS 17, at *44 n.27 (NASD NAC June 25, 2001)).

Davidofsky acted with the requisite scienter in this case. As an initial matter, the record demonstrates that Davidofsky intended to deceive Oppenheimer about his trading in JL's account. Between April 2008 and October 2008, Davidofsky used Oppenheimer's database management system, Insight Notes, to create false notes of conversations with JL in order to misrepresent to Oppenheimer that JL had given him authorization to trade in the account.

Moreover, we find that the high volume of trades that Davidofsky effected in JL's account was severely reckless and supports our finding of scienter. Over a ten-month period, Davidofsky transformed the account of a conservative investor with limited assets and minimal experience trading individual stocks into an extremely active account with routine in-and-out trading. Davidofsky effected 104 transactions in 38 different securities, on 61 different days during the relevant period. In an account that had an average monthly balance of $127,000, Davidofsky effected securities transactions that totaled more than $1.4 million. The cost-to-equity ratio and turnover rate for JL's account were so high that Davidofsky must have known that he was acting in reckless disregard of JL's interests – JL had to earn nearly 45 percent per year simply to break even.

Finally, the amount of commissions that Davidofsky generated from trading JL's account demonstrates that he acted with scienter. The $11,741.78 in commissions that Davidofsky earned from JL's account in 2008 represented a considerable source of income for him, particularly after his salary reduction for low production the prior year. Moreover, Davidofsky had been warned to get his numbers up. We conclude that Davidofsky undertook the highly active trading in JL's account to solidify his tenuous employment position at Oppenheimer and generate additional commissions for himself. *See Michael T. Studer*, Exchange Act Release No. 50543, 2004 SEC

[cont'd]

where cost-to-equity ratios ranged from 20 to 30 percent), *aff'd*, 2008 U.S. App. LEXIS 837, at *1 (2d Cir. 2008).

[31] The Hearing Panel noted that Davidofsky's excessive trading also violated NASD Rule 2120. NASD Rule 2120 requires a showing of scienter, similar to Exchange Act Rule 10b-5. We do not affirm a violation of Rule 2120 because scienter is not necessary to establish an excessive trading violation.

LEXIS 2347, at *16-17 (Oct. 14, 2004) (explaining that churning occurs when a broker "manages a client's account for the purposes of generating commissions"), *aff'd*, 148 F. App'x 58 (2d Cir. 2005). The record in this case establishes that Davidofsky churned JL's account, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Rules 2110 and 2120.

IV. Sanctions

The Hearing Panel barred Davidofsky for the unauthorized trading, imposed a separate bar for the excessive trading and churning, and ordered him to pay a fine of $11,741.78 as disgorgement. We affirm the Hearing Panel's sanctions.

A. Unauthorized Trading

FINRA's Sanction Guidelines for unauthorized trading recommend a fine of $5,000 to $75,000 and a suspension in any or all capacities for a period of 10 business days to one year.[32] In egregious cases, the Guidelines suggest a longer suspension of up to two years, or a bar.[33] In formulating sanctions, the Guidelines advise adjudicators to consider whether the respondent misunderstood his authority or the terms of the customer's orders and whether the respondent's unauthorized trading was egregious.[34]

The Guidelines identifies categories of egregious unauthorized trading: (1) quantitatively egregious unauthorized trading, i.e., unauthorized trading that is egregious because of the sheer number of unauthorized trades executed; (2) unauthorized trading accompanied by aggravating factors, such as efforts to conceal the unauthorized trading, attempts to evade regulatory investigative efforts, customer loss, or a history of similar misconduct; and (3) qualitatively egregious unauthorized trading, which is measured by the strength of the evidence and the respondent's motives in effecting the trades, i.e., whether the respondent acted in bad faith or as a result of a reasonable misunderstanding.[35]

We find, as an initial matter, that Davidofsky's trading in JL's individual retirement account was not the result of any misunderstanding. Davidofsky and JL each testified that JL did not grant Davidofsky discretionary authority to trade in her account, and Oppenheimer's telephone records establish, at a minimum, that Davidofsky did not discuss the 82 unauthorized trades with JL. Davidofsky therefore had no basis to believe that JL had authorized him to make the trades at issue.

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32 *See FINRA Sanction Guidelines* 98 (2011) (Unauthorized Transactions), http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf [hereinafter *Guidelines*]. We apply the applicable Guidelines in place at the time of this decision. *See id.* at 8.

33 *See id.* at 98.

34 *See id.* We also consider the General Principles Applicable to All Sanction Determinations and Principal Considerations in Determining Sanctions, which adjudicators consult in every disciplinary case. *See id.* at 2-7.

35 *See id.* at 98.

We also conclude that Davidofsky's unauthorized trading was quantitatively egregious. Over the course of 10 months, Davidofsky effected 82 unauthorized trades in JL's individual retirement account. The total number of unauthorized trades that Davidofsky executed is consistent with our prior findings of quantitatively egregious unauthorized trading.[36]

We similarly find that Davidofsky's trading was accompanied by aggravating factors. JL suffered trading losses, totaling $108,000, as a result of Davidofsky's misconduct, and the record supports that Davidofsky attempted to conceal the misconduct from Oppenheimer by using Insight Notes to create false notes of conversations with JL.

Finally, we conclude that Davidofsky's unauthorized trading was qualitatively egregious because it was motivated out of self-interest. Davidofsky was in severe financial distress when he began his unauthorized trading in JL's account. He was on the brink of bankruptcy, and Oppenheimer had warned him that he needed to increase his productivity. In response to these various professional and financial circumstances, Davidofsky traded in JL's account without her authorization to do so. Davidofsky ensured his own financial gain at JL's expense.

Our review of the evidence in the record leads us to conclude that Davidofsky's unauthorized trading was egregious, and we find that the Guidelines' recommendation of a bar is appropriate under the circumstances presented.

B. Excessive Trading and Churning

The Guidelines for excessive trading and churning advise us to consider a fine of $5,000 to $75,000 and a suspension in any or all capacities for a period of 10 business days to one year.[37] The Guidelines also suggest a longer suspension of up to two years, or a bar, in egregious cases.[38] Davidofsky's misconduct presents several aggravating factors, which lead us to conclude that this is an egregious case.

Over the course of 10 months, Davidofsky engaged in numerous violative acts.[39] He effected 104 trades in JL's individual retirement account, executing transactions that totaled more than $1.4 million. Davidofsky effected these trades on 61 different days during the relevant period, and on several occasions, he made multiple trades in a single day.

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36 *See, e.g.*, *Dep't of Enforcement v. Bond*, Complaint No. C10000210, 2002 NASD Discip. LEXIS 6, at *12 (NASD NAC Apr. 4, 2002) (finding quantitatively egregious conduct for 12 unauthorized trades); *Dist. Bus. Conduct Comm. v. Levy*, Complaint No. C07960085, 1998 NASD Discip. LEXIS 22, at *11 (NASD NAC Mar. 6, 1998) (finding quantitatively egregious conduct for 16 unauthorized trades).

37 *See Guidelines*, at 77 (Churning or Excessive Trading).

38 *See id.*

39 *See id.* at 6 (Principal Considerations in Determining Sanctions, Nos. 8, 9) (considering whether respondent engaged in numerous acts and whether the misconduct over an extended period of time).

Davidofsky's trading in JL's account was not just risky, but extremely so. He engaged in in-and-out trading that generated excessive turnover and cost-to-equity ratios. JL was a conservative investor, who invested primarily in mutual funds. JL's account history reflects that she did not engage in rapid trading and did not want to assume such a high degree of risk for her retirement account. Davidofsky blatantly disregarded JL's financial circumstances and investment objectives and excessively traded and churned her account.

Davidofsky gave no consideration to the excessive commissions that were depleting JL's account. To the contrary, he was focused on a trading strategy designed to enrich himself and solidify his position at Oppenheimer. The implementation of this strategy ensured Davidofsky's financial gain, allowing him to generate $11,741.78 in commissions for himself, while causing $108,000 in trading losses in JL's account.[40]

Davidofsky's conduct demonstrated a gross indifference to JL's interests, and as we formulate the appropriate sanctions for Davidofsky's excessive trading and churning, we conclude that serious sanctions are needed to protect the investing public. We therefore bar Davidofsky in all capacities.[41]

We also affirm the Hearing Panel's order that Davidofsky pay disgorgement.[42] "[D]isgorgement is intended to force wrongdoers to give up the amount by which they were unjustly enriched."[43] Disgorgement is appropriate in all sales practice cases, even where an individual is barred, if among other things, "the respondent has retained substantial ill-gotten gains."[44] Such is the case here, and we accordingly affirm the Hearing Panel's order that

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40 *See id.* at 6, 7 (Principal Considerations in Determining Sanctions, Nos. 11, 17) (considering whether respondent's misconduct resulted in injury to the investing public or respondent's monetary gain).

41 We consider, but reject, Davidofsky's arguments that Shalmi's management of JL's account, and the effect of the 2007 and 2008 securities market decline on JL's account, mitigate his misconduct. We note, as an initial matter, that Shalmi's conduct is irrelevant. The review period focused on Davidofsky's, not Shalmi's, management of JL's account, and it is Davidofsky's conduct that is under review in this case. *See Dist. Bus. Conduct Comm. v. Aspen Capital Group*, Complaint No. C3A940064, 1997 NASD Discip. LEXIS 53, at *11 (NASD NBCC Sept. 19, 1997) (explaining that third-party's potential wrongdoing had no bearing on respondent's misconduct). The securities market decline of 2007 and 2008 also does not mitigate the circumstances that led to the losses in JL's account. Poor market conditions simply do not explain the fact that Davidofsky intentionally traded in JL's account without JL's authorization or regard for JL's financial circumstances or investment objectives. *See Dep't of Enforcement v. Wilson*, Complaint No. 2007009403801, 2011 FINRA Discip. LEXIS 67, at *48 (FINRA NAC Dec. 28, 2011) (rejecting respondent's argument that market conditions should mitigate his misconduct).

42 *See Guidelines*, at 10 (Technical Matters).

43 *Michael David Sweeney*, 50 S.E.C. 761, 768 (1991).

44 *Guidelines*, at 10 (Technical Matters).

Davidofsky pay a fine of $11,741.78, as disgorgement.[45] We also order Davidofsky to pay prejudgment interest on the disgorgement.

This marks a reassessment of our policy regarding ordering prejudgment interest on disgorgement that is payable to FINRA. In two recent appeals, we declined to order respondents to pay prejudgment interest on disgorgement awards that we ordered paid to FINRA.[46] In doing so, we relied on one of our own cases, *Dist. Bus. Conduct Comm. v. G.K. Scott & Co.*, a 1992 decision.[47] Upon further consideration, we overrule *Scott* on this point. That decision failed to recognize that the purpose of disgorgement – whether it is to be paid to customers or to FINRA – is not to compensate, but rather to deprive a respondent of ill-gotten gains and unjust enrichment. By failing to order prejudgment interest on a disgorgement amount, an adjudicator falls short of achieving the proper deterrence for the misconduct because disgorgement alone does not reflect the time value of ill-gotten gains, and in effect, provides the respondent with an interest free loan until the disgorgement order is final. Likewise, failing to order prejudgment interest gives a respondent a perverse financial incentive to seek delay in the resolution of the proceeding. For these reasons, our past precedent in this area is now invalid. When assessing disgorgement, FINRA adjudicators should require payment of prejudgment interest on the amount to be disgorged, or explain in their decision why the payment of prejudgment interest is not appropriate to effectuate the purposes of equitable disgorgement. The rate of prejudgment interest is the rate established for the underpayment of income taxes in the Internal Revenue Code, which is the same rate we use when ordering interest on a restitution award.[48]

V. Conclusion

Davidofsky engaged in unauthorized trading, excessive trading, and churning in JL's individual retirement account. We bar Davidofsky for the unauthorized trading, impose a separate bar for his excessive trading and churning, and order Davidofsky to disgorge the financial benefit

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[45] Davidofsky suggests that he is unable to pay the fine. Davidofsky, however, has failed to establish an inability to pay. The Guidelines provide that, "[t]he burden is on the respondent to raise the issue of inability to pay and to provide evidence thereof." *Guidelines*, at 5. The Guidelines also advise adjudicators to "require respondents who raise the issue of inability to pay to document their financial status through the use of standard documents that [FINRA staff may provide]." *Id.* Davidofsky has proffered no evidence to support his inability to pay, and we accordingly order him to pay the assessed fine.

[46] *See Dep't of Enforcement v. Padilla*, Complaint No. 2006005786501, 2012 FINRA Discip. LEXIS 46, at *46 n.52 (FINRA NAC Aug. 1, 2012); *Murphy*, 2011 FINRA Discip. LEXIS 42, at *120-122.

[47] *See Dist. Bus. Conduct Comm. v. G.K. Scott & Co.*, Complaint No. NY-9026, 1992 NASD Discip. LEXIS 128 (NASD NBCC Apr. 30, 1992), *aff'd*, 51 S.E.C. 961 (1994), *petition for review denied*, 56 F.3d 1531 (D.C. Cir. 1995). We also note that our decision in *Scott* interpreted too narrowly the applicability of the Commission's decision in *Michael David Sweeney*, 50 S.E.C. 761, 768 (1991).

[48] *See Guidelines*, at 11.

from his misconduct as a fine in the amount of $11,741.78, plus interest at the rate established for the underpayment of income taxes in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a), from November 1, 2008, until paid. We affirm the Hearing Panel's order for Davidofsky to pay costs of $4,125.35, and we impose appeal costs of $1,485.99.[49] We have considered and reject without discussion all other arguments of the parties.[50]

On behalf of the National Adjudicatory Council,

Marcia E. Asquith,
Senior Vice President and Corporate Secretary

[49] Davidofsky requests that we waive the imposition of costs from the proceedings before the Hearing Panel and these appellate proceedings. FINRA's rules do not provide for a waiver of costs. The Hearing Panel found, and we affirmed, that Davidofsky violated the Commission's and FINRA's rules, and we have assessed the level of sanctions and costs that we deemed appropriate under the circumstances presented. *See* FINRA Rule 8330 (associated persons "shall bear such costs of the proceeding as the [a]djudicator deems fair and appropriate under the circumstances"); *see also N. Woodward Fin. Corp.*, Exchange Act Release No. 60505, 2009 SEC LEXIS 2796, at *22 (Aug. 14, 2009) (rejecting respondents' request for reimbursement of costs and expenses).

[50] The bars are effective as of the date of this decision.