

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

District Business Conduct Committee
for District No. 2,

Complainant,

vs.

Aaron Eugene Granath
Los Angeles, California

Respondent.

DECISION

Complaint No. C02970007

District No. 2

Dated: March 6, 1998

Aaron Eugene Granath ("Granath") has appealed the July 25, 1997 decision of the District Business Conduct Committee for District No. 2 ("DBCC") pursuant to Procedural Rule 9310 of the NASD's Code of Procedure (now superseded).¹ For the reasons discussed below, we hold that Granath executed 24 unauthorized transactions in 10 customer accounts and that he violated Conduct Rules 2110 and 2120. We impose sanctions of a censure, a \$50,000 fine, a bar from associating with any member of the Association in any capacity, and hearing costs.

Background

Granath first entered the securities industry in May 1990. On August 19, 1992, Granath registered with Reynolds Kendrick Stratton, Inc. ("RKS"), a former NASD member, as a general securities representative. On November 26, 1993, Granath registered as a general securities principal of RKS, where he worked until July 25, 1994. He is currently registered as a general securities principal with W.J. Gallagher & Company, Inc., another NASD member.

¹ We cite here the Procedural Rules that were in effect at the time Granath appealed. We will apply the NASD's new procedural rules governing disciplinary proceedings to cases served on a respondent on or after August 7, 1997 and appealed or called for review. See Special Notice to Members 97-55 (August 1997).

Facts

The one-cause complaint, issued on January 27, 1997, alleged that from November 19, 1993 through March 30, 1994, Granath engaged in the type of activity described in IM-2310-2(b)(4)(iii),² in that he executed 24 unauthorized purchase and sale securities transactions in 10 customer accounts in violation of Conduct Rules 2110 and 2120.³

Granath admitted in his answer that the transactions in nine of the accounts were not authorized by the account holders, but he alleged that the trades were executed due to clerical errors and were authorized by customers other than the account holders. With respect to the alleged unauthorized transaction in the tenth account, Granath contended that the account holder, customer H.W. ("H.W."), gave him price and time discretion to execute the trade.

The Nine "Dead" Accounts. In November 1993, RKS' clearing operation assigned inactive or abandoned accounts known as "dead accounts" to approximately 16 brokers on the retail floor of RKS' Beverly Hills branch office. These accounts were delivered in bundles of computer printouts known as "white sheets" to the brokers who were responsible for attempting to locate the lost account holders. Nine of the accounts listed on Schedule A are such "dead" accounts.⁴

Granath testified that as he received the white sheets, he copied the lost account holders' names, account numbers, and addresses from the information on the white sheets to a legal pad.⁵ He also separately prepared an account position card for each customer with that same information for his trade book. Granath stated that when he located missing account holders, his typical "strategy" was to suggest that they liquidate their accounts and purchase stocks recommended by RKS. Granath claimed that when

² This interpretative material, IM-2310-2(b) (Fair Dealings with Customers) states, in pertinent part:

(4) Fraudulent Activity. (A) Numerous instances of fraudulent conduct have been acted upon by the Association and have resulted in penalties against members. Among some of these activities are: . . . (iii) Unauthorized Transactions. Causing the execution of transactions which are unauthorized by customers or the sending of confirmations in order to cause customers to accept transactions not actually agreed upon.

³ Schedule A attached to this decision describes these transactions.

⁴ Granath contended that he was assigned approximately 400 to 500 of these dead accounts and that he located a total of approximately 250 lost clients. He also stated that more than half of the 35 to 40 account holders that he listed on each sheet of paper agreed to trade in their accounts. Granath claimed that he had about 100 accounts before receiving the white sheets, and that by the time he left RKS, this number had grown to about 500 accounts.

⁵ According to Granath, he disposed of his list when he discovered the errors and realized that the list would no longer be useful to him.

he located a customer who agreed to this strategy, he placed a check mark on the right side of his list next to the customer's account. Granath described how he placed orders for the accounts designated with a check mark, by referring to his list, and then referring to the account's position card in his trade book, from which he wrote the order tickets.⁶

Granath stated that some months later while he was working through his list a second time, he contacted two or three clients who claimed to have already spoken to him, and he realized that he must have made an error in his "organizational system." Granath contended that he had isolated the nine accounts in which the trading errors occurred by comparing the check marks on his handwritten list to his trade book, and after calling the customers whom he previously had contacted. According to Granath, he advised Harold Harris ("Harris"), RKS' operations manager in the San Francisco branch, of the errors, and he subsequently provided Harris with a list of the nine accounts at a meeting held in San Francisco on February 7, 1995, which was also attended by RKS' Vice-President, Robert Kendrick ("Kendrick"), and the Beverly Hills branch office manager, Jeffrey Kahn ("Kahn").⁷ At the meeting, Granath agreed to reverse the trades in the nine accounts, to make payment to restore the accounts to their original positions, and to return the commissions he had received.

RKS' compliance officer, Kim Bolechala ("Bolechala"), provided a different description of the circumstances surrounding the alleged unauthorized trades. On about February 2, 1994, Bolechala conducted an internal investigation of Granath that was triggered by a phone call regarding an allegedly unauthorized trade involving an unrelated account. Bolechala examined Granath's trading activities in other accounts. He noticed that certain trades were made in two accounts that were marked with an "RET" designation, indicating that mail to those customers had been returned. Bolechala suspected that the account holders therefore had not approved the trades. Bolechala testified that he informed Kendrick of the apparent unauthorized trading in the "dead" accounts and advised him to ask Granath if unauthorized trades had occurred in any other accounts. According to Bolechala, Kendrick arranged the February 7, 1995 meeting to confront Granath about the unauthorized trades. On the day of the meeting, Harris faxed a list of the nine accounts to Bolechala, and Bolechala reversed the trades. Kendrick assigned Granath to be the assistant of Ellis Crasnou (phonetic) ("Crasnou"), who was the assistant to the Beverly Hills office manager. According to Bolechala, although this appeared to be a promotion, it was designed to permit Crasnou to "watch" Granath. Bolechala admitted that in spite of this measure, Granath was permitted to supervise the floor on his own at times.

The H.W. Account. The tenth account listed on Schedule A was a "dead" account until Granath located H.W., the holder of the account. H.W. had held some penny stocks with another brokerage firm, and when that firm went out of business, the stocks were transferred to an account at RKS. H.W. testified that in 1993, Granath telephoned him and stated that he (Granath) had been assigned to H.W.'s account. H.W. stated that Granath discussed certain stocks in the account that had grown in value, and

⁶ Granath claimed that because the lost account holders were normally contacted in the afternoon or after trading hours, he generally submitted the order tickets at the opening of the market the following trade day.

⁷ Granath contended that he arranged this meeting with Kendrick to discuss a promotion.

Granath suggested that H.W. sell them and apply the proceeds to buy stock in two companies, Hariston Corporation ("HRSNF") and Health Care Products ("HCPAF"). H.W. agreed and asked Granath to do some research on other stocks that H.W. owned. A few days later, Granath called and recommended that H.W. sell those stocks. H.W. transferred the stocks to the RKS account, had them liquidated, and on December 7, 1993, purchased more HRSNF and stock in Western Pacific Resources on Granath's recommendation.

According to H.W., however, in January 1994, he received a confirmation in the mail for an unauthorized purchase of 9,000 shares of HCPAF. H.W. claimed that he contacted Granath immediately, and that Granath informed him that the transaction was a mistake, but that since the stocks were rising in value, he would attempt to "battle with [the] firm" to allow H.W. to buy them on margin. H.W. stated that he agreed to accept the stock in part because Granath had been correct in recommending that he liquidate certain stocks that had declined in value. According to H.W., he did not speak to Granath again until March, when he called to inquire about the price of a stock.

On about April 5, 1994, H.W. received a confirmation for the purchase on March 30, 1994 of 13,000 shares of Latex Resources Warrants ("LATXW"), the trade in H.W.'s account that is the subject of this complaint. H.W. claimed that he immediately complained to Granath, wrote on the confirmation that the transaction was a mistake, and mailed the confirmation back to RKS. When H.W. returned from a vacation on May 3, 1994, he received confirmations for an April 19, 1994 "sell-out" of 3,655 shares of LATXW, and 1,400 shares of another stock due to his "failure to pay." RKS also sent H.W. a margin call requesting that he deposit \$325 with the firm. H.W. immediately contacted RKS to complain and was referred to Bolechala. Bolechala reviewed the matter and reversed the March 30, 1994 LATXW trade.

Discussion

Granath does not dispute that he traded in the nine "dead" accounts without the authorization of the account holders. He claims, however, that the trades were executed in those accounts due to clerical errors and were authorized by other customers. He also claims that he brought the errors to his manager's attention, that he corrected the errors when they were discovered, and that he willingly paid for any losses to the accounts and returned all commissions.⁸

The DBCC determined that respondent's trading was not mistaken, and was more likely than not "purposeful," for the following reasons: First, Granath could not recall in which accounts the trades were supposed to have occurred, nor could he recall the names of any customers who purportedly authorized the trades. Second, Granath kept position cards on the inactive accounts in his trade book, but the cards did not indicate updated address and telephone numbers,⁹ nor did they reflect any information regarding

⁸ RKS' gross commissions for the trades were \$19, 274.12, and Granath received commissions of \$9,489.86. Granath apparently returned \$8,359.36 in commissions for the reversed trades.

⁹ Granath claimed that it was RKS' policy that any changes to the firm's customer records were required to be submitted in writing by the customer.

suitability. Third, no customers who purportedly authorized the trades had "laid claim" to missing trades. The DBCC therefore determined that respondent violated Conduct Rules 2120 and 2110.

Conduct Rule 2120 states that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive, or contrivance." The DBCC reasoned that because IM-2310-2(b)(4)(iii) specifies that fraudulent activity includes "causing the execution of transactions which are unauthorized by customers," and because Granath executed unauthorized transactions, Granath violated Rule 2120. We disagree with the DBCC's rationale, but we agree with its finding of fraud.

Unauthorized trades, without more, do not constitute fraudulent activity under Rule 2120. Cf. Brophy v. Redivo, 725 F.2d 1218, 1220 (9th Cir. 1984) (analyzing unauthorized trading and claims for fraud under SEC Rule 10b-5, Rule 2120's counterpart under the federal securities laws). A finding of fraud requires a showing that the respondent acted with scienter. Scienter is defined as the mental state of knowingly intending to deceive, manipulate, or defraud. See Aaron v. SEC, 446 U.S. 680, 686-87 n.5 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Scienter is also established by a showing that a respondent acted with severe recklessness, or conduct defined as highly unreasonable involving not merely simple or excusable negligence, but an extreme departure from the standards of ordinary care. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991) (citing cases from 11 circuit courts of appeals holding that recklessness suffices to show scienter); In re Martin Herber Engelman, Exchange Act Rel. No. 35729 n.43 (May 18, 1995).

We find that respondent acted with scienter. In so finding, we have carefully examined the record and have determined that the trades in the nine inactive accounts could not have been made mistakenly. The evidence shows that Granath liquidated the entire positions in the nine dead accounts and that he purchased stock for those accounts in equal amounts. We find it highly unlikely that the specific instructions of the customers who purportedly authorized the trades were for trades in amounts that nearly exactly matched the holdings that were liquidated in the nine dead accounts. Although Granath claims that he only placed a check mark next to the accounts on his list to indicate that the customers agreed to liquidate their accounts and to use the proceeds to buy stocks in which RKS made a market, by respondent's own admissions, he made some other notations on his list to reflect his discussions with customers regarding the treatment of their holdings. For instance, in an interview conducted by NASD Regulation staff, in response to staff's question as to whether respondent recorded specific stocks or discussions with his "white sheet" customers, respondent stated: "I had the symbols already listed of what they held and we would discuss stock that we held and I would write in the margin the stock that was going to be purchased."¹⁰

¹⁰ When questioned by staff as to what information he obtained from customers, Granath responded: "I would write down in the margin whether to hold the position, whether to sell and send the proceeds, whether to do anything." Moreover, Granath's customer contact form for the H.W. account, which originated as a "dead account," contained notes regarding his initial contact with H.W. According to Bolechala, however, no customer contact forms could be located for the nine dead accounts in which Granath executed the unauthorized trades.

By respondent's own admission, the holdings in the nine "dead" accounts would certainly have conflicted with any notations on respondent's list reflecting the positions and purchase instructions of the account holders who purportedly authorized the trades. If Granath had placed check marks next to the wrong accounts as he claimed, then when he prepared order tickets for the trades from his trade book, he would have noticed that the dead accounts' positions differed from his trading requests. It is therefore inconceivable that respondent could have liquidated the "dead" accounts and mistakenly purchased stocks with the proceeds in amounts that were coincidentally the same as those authorized by other account holders. We therefore find that the trades in the nine accounts could not have been effected unless respondent intended to do so.¹¹

We also note that no customers complained of not having received confirmations or statements reflecting trades that they purportedly authorized. We find it particularly telling that Granath did not attempt to locate those customers who he claimed authorized the trades. If Granath truly had made erroneous trades in the nine accounts, he would have attempted to locate the customers who purportedly authorized the trades, if only to derive commissions from the trades.¹²

Finally, we note that the unauthorized purchases were of stocks in which RKS made markets and for which respondent therefore earned especially high commissions. In two instances, purchases preceded sales by two days. Granath knew that the accounts were abandoned, that the account holders would not receive confirmations of the trades, and that the trades would be concealed.

Respondent's trading in the nine "dead" accounts, knowing the trades to be unauthorized and concealed, violated Conduct Rule 2120, which prohibits the "purchase or sale" of any security by means of a "deceptive or fraudulent device." Cf. Cruse v. Equitable Securities of New York, 678 F. Supp. 1021, 1023 (S.D.N.Y. 1987) (allegation of unauthorized trading under corollary to Conduct Rule 2120, SEC Rule 10b-5, may be based on failure to obtain authorization); In re Martin Herer Engelman, Exchange Act Rel. No. 35729 (May 18, 1995) (finding fraudulent unauthorized trading under SEC Rule 10b-5).

We have considered Granath's assertion that he brought the allegedly erroneous trades to his supervisors' attention before he knew that RKS was investigating the unauthorized trading.¹³ In support

¹¹ Respondent acknowledges that he may not have recorded notes on the firm's records regarding his conversations with customers, and may only have made certain notes of client instructions on his handwritten list. He also acknowledges that he failed to take any notes regarding suitability, and he asserts that because he was "dealing with a very large list," his "check marks" indicated that customers met the "profile" of a suitable investor. The position cards of the nine accounts are contained in the record and reveal scant notations of only the account's holdings. We find that respondent's handling of the record-keeping surrounding the trading in nine accounts, at a minimum, indicates severe recklessness.

¹² Moreover, failure to execute the purportedly-authorized trades would constitute a violation of the Association's rules.

¹³ Granath attempted to call Harris as a witness at the DBCC hearing, but was unable to reach him by telephone. On appeal, Granath claims that Harris attempted to return the phone call during the

of his contention, respondent points to a declaration submitted by Harris which states that Granath informed him of the errors prior to the February 7, 1995 meeting. At the DBCC hearing, Jon Blizzard ("Blizzard"), an NASD Regulation, Inc. Supervisor in District No. 2, testified that Harris had stated in an interview that he was informed of the unauthorized trades not by Granath, but by Bolechala, pursuant to the internal investigation of Granath. According to Blizzard, however, Harris refused to sign a declaration stating this, and instead submitted the declaration stating that Granath had informed him of the trades before the February 7, 1995 meeting.¹⁴

We find that the evidence shows that Granath intended to execute the trades in the nine "dead" accounts as described above. Whether he in fact disclosed the unauthorized trades to Harris prior to the February 7, 1995 meeting does not address the key question of his initial intention to commit the unauthorized trades.¹⁵ Our finding is supported by respondent's extremely questionable method of handling the "dead" accounts, and by the fact that he made no effort to locate the account holders who purportedly authorized the trades.¹⁶

Turning to the unauthorized transaction in the tenth account, we find not credible Granath's argument that he had price and time discretion to effect the purchase of LATXW on March 30, 1994 in H.W.'s account. We note that in 1994, RKS' manual prohibited discretionary trading. We also note that, according to the customer contact sheet for the H.W. account, Granath's last contact with H.W. before the LATXW transaction was on March 17, 1994, and Granath made no notes reflecting H.W.'s purported approval of a LATXW trade. We note that H.W. immediately disputed the trade and promptly returned the confirmation of the LATXW trade to RKS. Accordingly, we hold that by effecting the unauthorized

hearing, but that the District No. 2 switchboard was closed. Regional counsel has indicated in her appeal brief that she received no messages from Harris on the answering machine for District No. 2.

¹⁴ On the day of the appeal hearing, regional counsel sent, via facsimile, to NASD Regulation's Office of General Counsel a copy of a letter from Harris dated December 5, 1997, which regional counsel apparently received on the day of the appeal hearing. At the appeal hearing, Granath sought to adduce this letter as additional evidence, and regional counsel did not object to the introduction of the first three paragraphs of the letter, which substantially duplicated information already contained in the record, *i.e.*, regarding Harris' contention that Granath had in fact voluntarily informed him of the trades. We deny respondent's motion to adduce this evidence for failure to meet the requirements of Procedural Rule 9346.

¹⁵ Even if Granath had voluntarily disclosed the trading in the nine accounts to Harris as he claims, this would not provide him with a defense. *See, e.g., In re Ernest A. Cipriani*, 51 S.E.C. 1004, 1007-08 (1994) (fact that respondent ultimately repaid customer affords no justification for misconduct; presumably misconduct would have continued had it remained undetected).

¹⁶ We also rely on the DBCC's finding that Bolechala's version of events surrounding the unauthorized trades was credible. *See In re Frank J. Custable*, 51 S.E.C. 643 (1993). The credibility determinations of an initial fact finder can be rejected only when the record contains "substantial evidence" opposing that determination. *In re Joseph H. O'Brien II*, 51 S.E.C. 1112 (1994).

trade in H.W.'s account, Granath violated Conduct Rule 2110. We reverse, however, the DBCC's finding that this unauthorized trade was part of the deceptive scheme surrounding Granath's trading in the nine inactive accounts in violation of Rule 2120.

Respondent's execution of the unauthorized transactions was also a violation of the obligation to observe just and equitable principles of trade required by Conduct Rule 2110. In re Thomas J. Kibler, 51 S.E.C. 297 (Feb. 23, 1993); see In re Keith L. De Santo, Exchange Act Release No. 35860 (June 19, 1995), aff'd, 101 F.3d 108 (2d Cir. 1996) (table); In re Robert Lester Gardner, Exchange Act Rel. No. 35899 (June 27, 1995).

Sanctions

In assessing sanctions, we note that respondent deliberately and deceptively executed 23 unauthorized transactions in nine inactive accounts over approximately three months, in violation of Conduct Rules 2110 and 2120. We also note that respondent subsequently effected one other unauthorized transaction in a customer account in violation of Conduct Rule 2110. This unauthorized transaction occurred only a little over a month after the unauthorized transactions in the nine accounts were revealed and reversed.

We do recognize that Granath has no disciplinary history. We note that although the trades were reversed and respondent has returned the commissions that he earned on the trades, this does not support a reduction in the sanctions. See, e.g., In re Ernest A. Cipriani, Jr., 51 S.E.C. 1004, 1007 (1994); In re Raymond M. Ramos, 49 S.E.C. 868, 871 (1988). Granath's deceptive trading in the nine accounts, and his denial of any wrongdoing, indicates a serious lack of trustworthiness and an egregious violation of his duty of fair dealing owed to his customers. We find that the DBCC's imposition of a \$25,000 fine should be increased to a \$50,000 fine, and that the DBCC's imposition of a two-year suspension should be increased to a bar, given the egregious nature of respondent's conduct.¹⁷ A bar, which is within in the range recommended by the NASD Sanction Guidelines ("Guidelines"), will prevent the investing public from being exposed again to respondent's repeated misconduct.¹⁸

¹⁷ On appellate review, the NAC is permitted to increase any sanctions imposed by the DBCC. In re Stanley D. Gardenswartz, 50 S.E.C. 95 (1989).

¹⁸ We find that these sanctions are consistent with the applicable Guideline which recommends imposition of a bar in certain cases. See Guidelines (1996 ed.) at 56 (Unauthorized Transactions).

Conclusion

Accordingly, we impose sanctions of a censure, a \$50,000 fine, and a bar from associating with any member in any capacity, DBCC hearing costs of \$927, and NAC hearing costs of \$750. The bar imposed is effective immediately upon issuance of this decision.¹⁹

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

¹⁹ We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.

NASDR Direct: (202) 728-6904
NASDR Fax: (202) 728-8264

March 6, 1998

VIA CERTIFIED MAIL: RETURN RECEIPT REQUESTED

Aaron Eugene Granath
Los Angeles, California

Re: Complaint No. C02970007: Aaron E. Granath

Dear Mr. Granath:

Enclosed herewith is the Decision of the National Adjudicatory Council in connection with the above-referenced matter. Any fine and costs assessed should be made payable and remitted to the National Association of Securities Dealers, Inc., Department #0651, Washington, D.C. 20073-0651.

You may appeal this decision to the U.S. Securities and Exchange Commission ("SEC"). To do so, you must file an application with the Commission within thirty days of your receipt of this decision. A copy of this application must be sent to the NASD Regulation, Inc. ("NASD Regulation") Office of General Counsel as must copies of all documents filed with the SEC. Any documents provided to the SEC via fax or overnight mail should also be provided to NASD Regulation by similar means.

Your application must identify the NASD Regulation case number, and set forth in summary form a brief statement of alleged errors in the determination and supporting reasons therefor. You must include an address where you may be served and phone number where you may be reached during business hours. If your address or phone number changes, you must advise the SEC and NASD Regulation. If you are represented by an attorney, he or she must file a notice of appearance.

The address of the SEC is:
Office of the Secretary
U.S. Securities and Exchange
Commission
450 Fifth Street, NW, Stop 6-9
Washington, DC 20549

The address of NASD Regulation is:
Office of General Counsel
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006

Questions regarding the appeal process may be directed to the Office of the Secretary at the SEC. The phone number of that office is 202-942-7070.

Very truly yours,

Joan C. Conley
Corporate Secretary

Enclosure

cc: Karol L. Pollock, Esq.