BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee for District No. 1, Complainant, vs. Respondent 1 Respondent.	DECISION Complaint No. C01960013 District No. 1 Dated: September 5, 1997

Respondent 1 has appealed, pursuant to NASD Procedural Rule 9310, a February 4, 1997, decision of the District Business Conduct Committee for District No. 1 ("DBCC"). We find that Respondent 1 violated NASD Conduct Rules 2110 and 2310 by making an unsuitable recommendation to two customers, although we decline to find that he effected unauthorized transactions in the account of one of the customers. We impose the following sanctions: censure and a $2,000 fine.

Factual Background

Respondent 1 entered the securities industry in 1988. Although he worked for seven firms between 1988 and 1993, at all times relevant to the complaint, he was associated with Firm A as a general securities representative. Respondent 1 remains associated with Firm A.

In the Summer of 1993, one of Respondent 1's clients referred him to Customer CP, an allegedly "wealthy woman" with whom this client had worked. At that time, Customer CP, along with her husband-had four children and owned a $250,000 home with a $200,000 mortgage. She had approximately $25,000 to $30,000 in a bank account from the divorce settlement of a prior marriage. Customer CP's husband owned 70 percent of a family-owned and operated commercial tile business; he and a partner owned the building in which the tile business was located. The Customer CP and her husband's joint adjusted gross incomes for 1992, 1993, and 1994 were $63,665, $26,861, and $69,486, respectively. At the time of her initial contact with Respondent 1, neither Customer CP nor her husband had had a securities account before, and she testified that she knew nothing about the stock market.

Customer CP opened four accounts with Respondent 1; one in her name, one in CP's husband's name, and two custodial accounts for her daughters.[1] Customer CP opened her personal account on September 9, 1993. The new account form indicated that she was married; owned her own home; was employed in the mortgage business; had $25,000 in annual income; and had a net worth of $300,000. All three investment objectives listed on the form -- appreciation with risk; appreciation with safety; and speculation -- were checked. Respondent 1 completed the new account form, and Customer CP signed the last page of the account form under the heading "Individuals Sign Here."

On September 29, 1993, Respondent 1 opened an account in the name of CP's husband ("JTWROS Account"). The new account card, again completed by Respondent 1, reported that CP's husband was married; was employed in sales by a title company**;** earned an annual income of $50,000; owned his home; and had a net worth of $400,000. Again, the account card listed all three possible investment objectives: appreciation with risk, appreciation with safety, and speculation. Although the account was in CP's husband's name, both spouses signed the form under the heading "Joint Tenants With Right of Survivorship Sign Here."

The Customers later disputed the information contained on the account opening forms. Customer CP testified that she told Respondent 1 that she wanted to make more money than she could at her bank and wanted to provide for her children's education. She testified that she had no discussions with concerning either her own or CP's husband's annual income or net worth. According to Customer CP, Respondent 1 knew that they owned their home, that CP's husband owned his tile business, and that they had four children. Customer CP denied that she told Respondent 1 that she had an annual income of $25,000 or that CP's husband had an annual income of $50,000. She further denied that she told Respondent 1 that she had a net worth of $300,000 or that CP's husband had a net worth of $400,000. Respondent 1 disputed each of these allegations.

Customer CP controlled the trading in all of the accounts and relied heavily upon Respondent 1's recommendations. She alleged that all transactions in their accounts were recommended by Respondent 1. Although some of the order tickets for these purchases were marked "unsolicited," Customer CP claimed that she did not know what "unsolicited" meant. CP's husband claimed that he never spoke with Respondent 1 about the purchases in the JTWROS Account, but admitted that Customer CP shared with him the recommendations and information she obtained from Respondent 1. CP's husband consented to this arrangement; he was uninterested in and unaware of the activity or holdings in the accounts.

Between August 1993 and December 31, 1993, Customer CP purchased nine different securities for the three accounts, all from Respondent 1: 1,650 shares of Atari Corporation stock for $6,659.38; 2,500 warrants of Diagnostic Health Services for $4,277.50; 800 units of Adaptive Solutions, Inc. for $9,600; 1,600 warrants of Black Hawk Gaming and Development for $2,955; 1,300 shares of Palomar Medical Technologies ("Palomar") common stock for $5,052.50; 300 units of Equivision, Inc. for $2,100; 200 units of Maxim Group, Inc. for $2,100; 1,150 shares of Helionetics, Inc. for $4,508; 900 shares of Go Video, Inc. for $2,665.50; and 10,000 warrants of Palomar for $16,280.

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[1] One of the custodial accounts was never used.

Respondent 1 recommended that she purchase 10,000 Palomar warrants, 8,000 in the Customer CP Account and 2,000 in the JTWROS Account. The purchases were made from Firm A's inventory. Gross compensation to the firm on the two purchases totaled $3,125. Respondent 1's portion was $1,406.25.

At the time she purchased the Palomar warrants, Customer CP held 1,300 shares of Palomar common stock. She knew that Palomar had completed phase one of three phases in developing a laser instrument for use in heart surgery, and she planned to hold the Palomar stock and warrants until Palomar finished phase three.

The prospectus that had been used in the initial public offering of Palomar units was dated December 18, 1992, approximately one year before the Customers' purchase of the Palomar warrants. It disclosed that Palomar had the option to redeem the warrants at five cents each:

> Commencing nine months from the date of this Prospectus, the warrants are subject to redemption at $0.05 per Warrant on 30 days written notice with the prior written consent of Thomas James Associates, Inc., as representative ("Thomas James" or the "Representative") of the several underwriters (the "Underwriters).

Firm A had participated in the underwriting of Palomar units. Palomar's stock and warrants had been unbundled following the initial public offering and traded separately.

In January 1995, Palomar called the warrants. When Customer CP learned this, she telephoned Respondent 1, who informed her that she had three options: to permit redemption at five cents each; to sell the warrants on the market for 12 cents each; or to exercise the warrants and pay five dollars for one and one-half shares per warrant. He advised that the Customers exercise the warrants, using funds obtained by liquidating their other holdings. The Customers permitted Palomar to redeem their warrants at five cents each, thereby sustaining a loss in both accounts totaling $15,780.

The Customers' subsequent customer complaint led to the May 28, 1996, issuance of a two-cause complaint against Respondent 1 alleging that Respondent 1's recommendation that Customer CP and her husband purchase 10,000 Palomar warrants was unsuitable and that Respondent 1 effected unauthorized transactions in the JTWROS Account, all in violation of Conduct Rules 2110 and 2310. As to cause one, the DBCC censured Respondent 1; fined him $6,406; required him to requalify as a general securities representative; and assessed him $1,210.70 in costs. The DBCC also ordered that its decision serve as a Letter of Caution regarding cause two. Respondent 1 appealed.

On June 5, 1997, a subcommittee ("Subcommittee") of the National Business Conduct Committee ("NBCC") held an appeal hearing on this matter. Respondent 1, Respondent 1's spouse, and the regional attorney who presented this case to the DBCC attended the hearing. [2]

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[2] The Subcommittee, in its discretion under NASD Procedural Rule 9312(a), granted Respondent 1's

Discussion

Respondent 1's appeal raises three issues: (1) whether the evidence supports the DBCC's finding that Respondent 1's recommendation that the Customers purchase 10,000 Palomar warrants was unsuitable given the Customers' sophistication and financial situation; (2) whether the record supports the DBCC's determination that the Customers' testimony about the recommendation was credible and that Respondent 1's testimony was not; and (3) whether Respondent 1 needed CP's husband's authorization to effect transactions in the JTWROS Account, given that: (a) Customer CP and her husband each signed the account opening form as joint tenants with right of survivorship; (b) CP's husband knowingly permitted Customer CP to control the activity in the account; and (c) Customer CP authorized the transactions. After a thorough review of the record and for the reasons discussed below, we affirm the finding of violation regarding cause one, reverse and dismiss the finding of violation regarding cause two, and modify the DBCC's imposition of sanctions.

As a threshold matter, we are mindful that the DBCC's decision relied heavily upon its credibility determinations, and that Respondent 1 strenuously challenges those credibility determinations. Respondent 1 and the Customers gave contradictory accounts of most of the significant events underlying the complaint. For example, Customer CP testified that she and Respondent 1 never discussed her annual income or net worth or CP's husband's annual income or net worth; Respondent 1 testified that they had. Customer CP testified that she did not receive a Palomar prospectus and that she did not understand that the warrants were callable; Respondent 1 testified that she requested the prospectus, that he sent it to her, and that he explained to her that the warrants were callable and what the implications of that concept were. Customer CP and her husband both testified that CP's husband never authorized Respondent 1, either verbally or in writing, to effect transactions in the JTWROS Account; Respondent 1 testified that CP's husband verbally authorized each transaction. In each instance, the DBCC made an explicit, detailed determination that the Customers' testimony was credible and that Respondent 1's was not.

The SEC has repeatedly instructed the NBCC to give "considerable weight" to the credibility determinations of the tribunal that actually heard the witnesses' testimony. In re Christopher J. Benz, Exchange Act Rel. No. 38440 (March 26, 1997); In re Frank J. Custable, 51 S.E.C. 643 (1993); In re Robert E. Gibbs, 51 S.E.C. 482 (1993); In re Anthony Tricarico, 51 S.E.C. 457 (1993); In re Mark Foglia, 51 S.E.C. 427 (1993); In re Jonathan Garrett Ornstein, 51 S.E.C. 135, 137 (1992). The credibility determinations by an initial fact finder can only be rejected where the record contains "substantial evidence" for doing so. In re Joseph H. O'Brien, II, 51 S.E.C. 1112 (1994). After carefully considering the DBCC hearing transcript as a whole and the specific exchanges that Respondent 1 identified in his appeal, we conclude that the DBCC=s credibility determinations are entitled to considerable weight.

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motion to adduce evidence not presented to the DBCC: (1) evidence of unsolicited sales of securities by Customer CP in February 1996; and (2) an agreement between the Customers and Firm A resolving an arbitration arising from the events that triggered this disciplinary proceeding. We affirm the Subcommittee's ruling an this motion.

Unsuitable Recommendation. Conduct Rule 2310 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." This rule obligates representatives to make a customer-specific determination of suitability and to tailor their recommendations to the customer's financial profile and investment objectives. In re F.N. Kaufman & Co. of Virginia, 50 S.E.C. 164 (1989).

It is undisputed that prior to meeting Respondent 1, the Customers were inexperienced investors, and that Respondent 1 knew that. Neither CP nor CP's husband had ever opened a securities trading account, purchased a security, or even purchased a mutual fund. They kept their savings in a savings account at a bank. Yet, in the brief time between meeting Respondent 1 and purchasing the Palomar warrants at issue here, the Customers purchased through Respondent 1 several low-priced, speculative stocks, units in several even-riskier initial public offerings ("IPOs"), and several blocks of riskier-still, callable warrants. Each unit, common stock, and warrant the Customers purchased through Respondent 1 was one in which Firm A made a market; several IPOs were ones in which Firm A had participated; and some of the warrants were unbundled from units that Firm A had participated in offering.

Respondent 1 claims that Customer CP understood and desired this level of risk. He testified that Customer CP was interested in participating in as many initial public offerings as possible based upon her prior conversations with a friend who was a stockbroker. Respondent 1 testified that Customer CP told him that the money coming into her account came from her real estate business. He stated that she had rejected one of his recommendations and had solicited several other transactions. Finally, he testified that Customer CP and her husband provided him with the information contained on the new account forms, which indicated that the Customers had a combined net worth of $700,000 and combined income of $75,000.

Respondent 1 said that when he first recommended warrants to CP she was already familiar with warrants. Customer CP had earlier purchased 1,300 shares of Palomar common stock and was familiar with the company and its business. Respondent 1 stated that, at her request, he provided a prospectus on the earlier initial public offering of Palomar units to Customer CP prior to the warrant purchases. Respondent 1 testified that he had previously sent her prospectuses on other IPOs involving callable warrants similar to Palomar's; that he and Customer CP had discussed the risks associated with such warrants; and that Customer CP had told him she had read an earlier prospectus "back to back." Respondent 1 said that he specifically discussed the 30-day call feature on Palomar warrants with Customer CP before her purchase. It was against this background, Respondent 1 claimed, that he recommended the Palomar warrants to her.

Customer CP told a different story. She claimed to have told Respondent 1 that the money she was investing was her savings from a divorce settlement and that the money was intended to pay for her children's education. She testified that Respondent 1 never inquired about the Customers' net worth or income. Customer CP claimed that she never rejected Respondent 1's recommendations or engaged in unsolicited trading. She testified that she never requested or received the prospectus for Palomar. She admitted having purchased

warrants and participated in previous IPOs of units whose prospectuses may have contained a redemption provision. She testified, however, that she did not understand either the risks associated with warrants or the concept of redemption; that Respondent 1 never discussed the redemption provision with her; and that she did not read the prospectuses or notice that provision because Respondent 1 advised her to hold IPOs only briefly.

After hearing the often-conflicting testimony of Customer CP, her husband, and Respondent 1, and observing their demeanor, the DBCC concluded that the Pavones' testimony was credible and that Respondent 1's was not.

On appeal, Respondent 1 challenged the DBCC's credibility determinations. Respondent 1 argued that: (1) Customer CP's testimony was inconsistent with her earlier statements or with other evidence;[3] (2) the Customers' testimony was self-serving because they intended to, and did in fact, submit a claim to arbitration against Firm A;[4] (3) several exhibits corroborated his testimony and contradicted the Customers' testimony;[5] and (4) the DBCC misconstrued Respondent 1's professional skills.[6] Respondent 1's arguments are not completely without merit.[7] Unfortunately for Respondent 1, the DBCC reviewed the same evidence and arguments that are before us now, with the added benefit of observing the witnesses' demeanor. After carefully reviewing the record and arguments on appeal, we conclude that the DBCC's credibility determinations are entitled to considerable weight and should not be overturned.

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[3] At various times, Customer CP assessed the value of their house as ranging from $250,000 to $375,000, with varying amounts of equity.

[4] The DBCC concluded that the Customers did not understand the concept of risk until it was explained to them at the hearing. We find that although the Customers may not have fully understood the risks associated with the Palomar warrants, nothing in the record indicates that they failed to grasp the concept of risk writ large.

[5] Although Cheryl Customers claimed never to have solicited trades, several of the confirmation statements for trades in the Customers' accounts were marked "unsolicited," at a time when Respondent 1 had no apparent motivation to falsify the forms.

[6] We disagree with the DBCC's conclusion that Respondent 1 did not recognize that the three investment objectives that Respondent 1 indicated on the Customers' new account forms -- appreciation with safety; appreciation with risk; and speculation -- were contradictory. Respondent 1 plausibly explained that a customer's objectives might be fluid or indeterminate.

[7] We reject Respondent 1's argument that the staff was biased against him. He claims as evidence of bias, the fact that early in the investigation, an NASD examiner expressed doubts about whether a suitability case could be sustained against Respondent 1, but later concluded that it could. Respondent 1 overlooks later developments in the investigation, such as the examiner's suibsequent interviews of both Cheryl Customers' and Respondent 1 himself.

Based, in part, on the DBCC's credibility determinations, we find that Respondent 1 violated his duty to the Customers by recommending that they purchase 10,000 Palomar warrants. Respondent 1 was required to counsel the Customers in a manner consistent with their financial situation, even if they wished to engage in trading that was not consistent with their financial needs and investment goals. In re Paul F. Wickswat, 50 S.E.C. 785 (1991); In re Clyde J. Bruff, 50 S.E.C. 1266 (1992). Respondent 1 failed to fulfill this duty. Respondent 1 was obligated to satisfy himself that the Customers understood the risks associated with the Palomar warrants and that they were both able and willing to take those risks. In re Arthur Joseph Lewis, 50 S.E.C. 747 (1991). The record does not establish that Respondent 1 attempted to satisfy himself in such a manner.

Based upon the Customers' investment experience, financial condition, and needs, Respondent 1's recommendation that the Customers purchase 10,000 Palomar warrants was unsuitable and violated Conduct Rule 2310. Respondent 1's conduct also violated Conduct Rule 2110 because it violated the high standards of commercial honor and just and equitable principles of trade that Conduct Rule 2110 demands.

Unauthorized Transactions. The Securities and Exchange Commission has long recognized that a registered representative who effects unauthorized transactions in a customer's account violates the broad ethical principles contained in Conduct Rule 2110. See In re Keith L. DeSanto, Exchange Act Rel. No. 35860 (June 19, 1995); In re Robert Lester Gardner, Exchange Act Rel. No. 35899 (June 27, 1995).[8] The DBCC found that the JTWROS Account was established as the individual account of CP's husband, and that, since CP's husband did not authorize the trades in that account, Respondent 1 effected unauthorized trades.[9] We disagree.

It is not clear that the Customers established the JTWROS Account as an individual account for CP's husband. On the final page of the account opening form, both completed the signature block marked "Joint Tenants With Right Of Survivorship Sign Here" rather than the blocks marked "Individual Sign Here" or "Tenants In Common Complete Paragraph 14(e) and Sign Here." Customer CP must have recognized the difference between the signature blocks; she alone signed her account opening form as "Individual."

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[8] The DBCC made no specific findings with respect to Conduct Rule 2310. The Commission has determined that unauthorized trades are "recommended" and may be found to be unsuitable as well as unauthorized. In re Patrick G. Keel, 51 S.E.C. 282 (1993) (in executing securities transactions for a customer, the broker implicitly recommended such securities). Thus, even though the DBCC concluded that Respondent 1 did not speak with CP's husband about purchases in the JTWROS Account, the DBCC could still find that those "recommendations" were unsuitable and violated Conduct Rule 2310.

[9] Again, the parties contradict each other: CP's husband testified that he never spoke with Respondent 1 prior to the DBCC hearing; Respondent 1 testified that he spoke with CP's husband at the opening of the account and with regard to each transaction. Again, the DBCC credited CP's husband's testimony and not Respondent 1's.

Directly above the Customers' signatures, the JTWROS signature block reads: "[w]e hereby request and authorize you to open a joint account in our names . . ." (emphasis added). On the same page, a provision entitled "Provisions Applicable to Joint Accounts" explains that either of the joint tenants may authorize trades in the account:

> (a) Authority of Parties -- Each of us shall have complete authority on behalf of the joint account: (i) to buy, sell (including short sales) or otherwise deal in securities or other property for cash, margin or otherwise; (ii) to receive demands, notices, confirmations, reports, statements, and correspondence; (iii) to receive or withdraw any and all property in the joint account; (iv) to enter into and execute agreements on behalf of the joint account and to terminate or modify same or waive any of the provisions thereof; and (v) generally to deal with you on behalf of the joint account as fully and completely as if each alone were interested in said account, all without notice to the other or others interested in said account.

Thus, while only CP's husband employment and financial information appear on the account opening form and he is the only addressee on the account statements and confirmations, the joint signatures effectively authorized Customer CP to trade in that account.

.The Customers admitted that they intended Respondent 1 to act on Customer CP's authority. CP's husband testified that he knew that Customer CP was trading in the account, that he expected her to trade in the account, and that he would have taken any steps necessary to enable her to do so. Firm A sent CP's husband confirmations and account statements indicating that trades were occurring in the JTWROS Account, yet he never objected.

Under these conditions, we cannot find that Respondent 1 effected unauthorized trades in the JTWROS Account. Accordingly, we reverse the DBCC's findings of violation and cause two of the complaint is dismissed.

Sanctions

In addition to reversing the findings of violation and dismissing cause two of the complaint, we find that several factors warrant imposing only a small fine. The complaint involves a single recommendation made to a single pair of married customers that resulted in a commission of $1,406.25. The Customers have received restitution from Firm A. While mindful of the DBCC's credibility determinations, we conclude that Respondent 1's breach of duty was the result of his misapprehension as to the Customers' sophistication and willingness and ability to undertake the risks associated with his recommendation. Respondent 1 has no prior disciplinary history.

Respondent 1 need not requalify by examination or pay the hearing costs below as the DBCC ordered.[10] Because we have dismissed cause two of the complaint, there is no need for this decision to serve as a Letter of Caution with respect to that cause.

Accordingly, we order that Respondent 1 be censured and fined $2,000.

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

[10] We note that these sanctions are below the applicable NASD Sanction Guideline (1993 ed.) for suitability and unauthorized transactions.

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 be summarily 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 be summarily revoked for non-payment.