BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. Dana N. Frankfort Marina Del Rey, CA, Respondent.	DECISION Complaint No. C02040032 Dated: May 24, 2007

Respondent violated the antifraud provisions of the federal securities laws and NASD rules by failing to disclose material information when recommending an investment to customers. Respondent also violated NASD rules by engaging in private securities transactions without the prior approval of his firm and making an unsuitable recommendation. Held, findings affirmed and sanctions modified.

Appearances

For the Complainant: Cynthia A. Kittle, Esq., Leo F. Orenstein, Esq., Department of Enforcement, NASD

For Respondent: H. Thomas Fehn, Esq., Gregory J. Sherwin, Esq.

Decision

Dana N. Frankfort ("Frankfort") appeals a February 1, 2006 decision of an NASD Hearing Panel. The Hearing Panel found that Frankfort failed to disclose to customers the losses suffered by a private options fund known as the Summit Asset Fund, L.P. ("the Fund"), in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), SEC Rule 10b-5, and NASD Conduct Rules 2120 and 2110; recommended an unsuitable purchase of an interest in the Fund to one customer, in violation of NASD Conduct Rules 2310 and 2110; and participated in the sale of interests in the Fund without obtaining the prior written approval of his employer, in violation of NASD Conduct Rules 3040 and 2110. The Hearing Panel barred Frankfort for each violation. After a complete review of the record, we affirm the Hearing Panel's findings of violation but modify the sanctions imposed. We affirm the Hearing Panel's

imposition of a bar for the fraud violation and a separate bar for the suitability violation, but impose a one-year suspension and $50,000 fine for the private securities transactions.

I. Background

Frankfort entered the securities industry and first registered as a general securities representative in 1992. He has been associated with several NASD member firms since he entered the securities industry. Frankfort's conduct relevant to this decision occurred while he was associated with Brookstreet Securities Corporation ("Brookstreet" or the "Firm"). Frankfort registered with Brookstreet on April 13, 2000, and he remains employed by the Firm as a general securities representative.

II. Procedural History

The Department of Enforcement ("Enforcement") filed a three-cause complaint against Frankfort on August 16, 2004. The complaint alleged that Frankfort failed to disclose to customers certain material information about the Fund, recommended the Fund to two customers without having reasonable grounds for believing that the recommendations were suitable, and participated in the sale of interests in the Fund to two customers without obtaining the prior approval of Brookstreet. Frankfort denied any wrongdoing.

The Hearing Panel held a hearing from May 24 through May 27, 2005. Enforcement presented six witnesses: an NASD investigator; two of Frankfort's customers (DC and JVH); Frankfort's supervisor at Brookstreet, Stanley Brooks ("Brooks"); a vice president of Fidelity Investment Institutional Brokerage Group ("Fidelity");[1] and Frankfort's de facto partner at the Fund, Siamak Derakhshani ("Derakhshani"). Frankfort testified on his own behalf. On February 1, 2006, the Hearing Panel issued its decision in which it found that Frankfort violated the antifraud provisions of the federal securities laws and NASD rules and violated Conduct Rules 2310, 3040, and 2110. The Hearing Panel barred Frankfort. This appeal followed.

III. Procedural Arguments

On September 9, 2005, Frankfort filed a motion to dismiss the complaint, alleging prosecutorial misconduct by Enforcement for failing to disclose certain documents under Procedural Rule 9251 and presenting purportedly inadmissible hearsay evidence through an NASD investigator that was contradicted by the investigator's internal memorandum. Frankfort specifically alleged that Enforcement failed to disclose an auditor compilation report for the Fund's June 30, 2002 financial statements, which Enforcement had requested but did not obtain; a press release that announced Frankfort's association with Brookstreet that Enforcement obtained via an internet search on a publicly available web site after its investigation was completed; a memorandum that the NASD investigator prepared regarding a conversation that he

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[1] Fidelity provided clearing services for the Fund.

had with one of Frankfort's customers, RS, upon which Frankfort contended that the Hearing Panel relied; certain customer account documents that Enforcement received from Derakhshani during the hearing; and Derakhshani's e-mails that Enforcement received five days before the hearing.[2] The Hearing Officer denied the motion, finding that Enforcement engaged in no misconduct and did not present inadmissible evidence. Frankfort challenges the Hearing Officer's determination. We affirm the ruling.

Procedural Rule 9251 requires that Enforcement provide the respondent, for inspection and copying, the documents prepared or obtained in connection with Enforcement's investigation or documents obtained pursuant to Procedural Rule 8210 after the complaint was filed. The auditor's report, the press release, and Derakhshani's e-mails were not part of Enforcement's investigative file nor were they obtained post-complaint pursuant to Rule 8210; thus, Enforcement was not required to produce them. Enforcement received the customer account documents pursuant to Rule 8210 during the hearing. Enforcement offered these documents into evidence later that same day, at which time the Hearing Officer adjourned the hearing to provide Frankfort the opportunity to review the documents overnight. Regarding the NASD investigator's memorandum, Rule 9251(b)(1) allows Enforcement to withhold an internal memorandum or writing prepared by an NASD employee.[3] The Hearing Officer ordered that the memorandum be provided to Frankfort because the investigator referred to the document during the investigator's hearing testimony. Frankfort later offered and the Hearing Officer admitted the memorandum into evidence. In denying this portion of Frankfort's motion, the Hearing Officer determined, and we agree, that the memorandum and the investigator's testimony were consistent with other evidence presented at the hearing contrary to Frankfort's assertion. Moreover, there is no evidence that the Hearing Panel relied on anything but live witness testimony and admitted record evidence in reaching its decision. The Hearing Officer further found that even if Enforcement failed to comply with Rule 9251, any error was harmless.[4]

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[2] The memorandum consisted of the investigator's notes from a discussion with customer RS about RS transferring $450,000 to the Fund.

[3] Rule 9251(b)(2) provides that "[n]othing in subparagraph (b)(1) authorizes the Department of Enforcement . . . to withhold a Document , or part thereof, that contains material exculpatory evidence."

[4] Frankfort further contends that "this investigation was conducted in an argumentative and prejudicial manner." Frankfort offers no evidence to substantiate his claim that he was denied a fair hearing, and we find none.

IV. Facts

A. Formation of the Summit Asset Fund

Frankfort met Derakhshani, an insurance agent, through mutual acquaintances in approximately 1997 when they both worked in the same office building. At the time, Frankfort was a registered representative working with JS, who was another registered representative. Frankfort and JS shared a joint representative number. Derakhshani and Frankfort periodically discussed their personal investment strategies, including their shared interest in writing put options. Soon their discussions turned to starting their own pooled investment vehicle through which they could utilize a put writing strategy. Frankfort was registered with a member firm at the time and did not want to terminate his association and forfeit his book of business.[5] Thus, he and Derakhshani reached an agreement whereby Derakhshani would form the investment vehicle and Frankfort later would participate in the operations and be responsible for raising capital.

In 1999, Derakhshani formed Trinity Asset Management, LLC, later known as Summit Asset Management, LLC ("Summit"), and organized the Fund. Summit, through Derakhshani, was the general partner of the Fund, had the exclusive power and authority to manage the Fund, and was the Fund's investment adviser. Summit was to receive from the Fund an annual management fee equal to one percent of the capital account of each investor in the Fund's limited partnership interests ("limited partner") and an incentive allocation of 20 percent of the net profits allocated to each limited partner. Derakhshani, as Summit's principal executive officer, served as the Fund's portfolio manager.[6] The Fund's October 1999 Private Placement Memorandum ("PPM") stated that the Fund's investment objective was to maximize long-term capital appreciation and that the Fund would initially attempt to achieve this through "trading [ ] and investing in put options on securities or various indices."

The PPM provided that the minimum investment in the Fund was $250,000 and that limited partners were required to invest in the Fund for at least one year before they were permitted to withdraw from the Fund. A limited partner could withdraw funds, subject to certain dollar limitations, only on a specified day after giving 90-days' written notice unless Summit consented otherwise.

Investors could invest directly in the Fund through the PPM or through a self-directed, tax-deferred annuity provided by AGL Life Assurance Company ("AGL"), in which the Fund

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[5] Frankfort terminated his registration with this member firm on February 24, 2000, in order to take on a direct role in the Fund.

[6] In 1999, Derakhshani became registered as an investment adviser and general securities representative. Prior to 1999, he had never been registered with NASD.

was a sub-account.[7] The minimum premium payment under the AGL policy was $250,000. AGL drafted a separate private placement memorandum ("AGL PPM") in August 1999, which it revised in February 2000 and supplemented in March 2000. The AGL PPM disclosed that the Fund would "initially attempt to achieve its investment objectives by trading [ ] and investing in 'put' options on securities and various indices." A policy owner could withdraw a portion of the policy's value at any time so long as the remaining value was at least $100,000.

B. Frankfort's Involvement with the Fund

Frankfort never formally became a partner in Summit. From the outset, however, he was central to the Fund's management. Frankfort participated in the formation decisions, paid approximately one half of the formation expenses, and he, along with Derakhshani, met with the attorneys preparing the offering documents. Frankfort also participated in selecting Fidelity as the Fund's clearing firm. According to Derakhshani, Frankfort precluded Derakhshani from meeting with investors. Rather, Frankfort solicited investors and raised all of the Fund's capital, and Derakhshani was to be primarily responsible for the Fund's trading decisions.

Frankfort also held himself out to the public as a partner of Summit. Frankfort identified himself as senior managing partner of Summit on business cards that he distributed and on letters that he signed on Summit letterhead. He also told prospective investors that he "was going to help run the fund." In addition, Frankfort stated that he was a general partner for the Fund on the outside business activities form that he submitted to Brookstreet on or about April 10, 2000.[8]

Frankfort solicited, and the Fund received monies from, 10 investors. Frankfort stipulated that he provided written or oral information regarding the Fund to potential investors, including to DC, on behalf of MC, and SW. The first investors in the Fund were Frankfort's parents and his aunt and uncle. They invested a total of $1.25 million. Frankfort raised more than $3.8 million for the Fund from February 29, 2000, to July 7, 2000.

On February 15, 2000, Derakhshani opened an account at Fidelity in order to begin writing put options for the Fund. Frankfort was not an authorized individual on the Fidelity account, did not have access to the on-line account statements, and did not receive Fidelity account statements from Derakhshani. Frankfort testified that he "didn't know the specific performance of the fund." Frankfort admitted, however, that he had periodic discussions with Derakhshani about the market's condition at the time and that he engaged in a parallel trading strategy to the Fund in his personal account. Frankfort further admitted that in March and April 2000, he was generally aware of the Fund's financial condition. According to Derakhshani, he and Frankfort were in regular communication regarding trading in the Fund. Derakhshani

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[7] The AGL annuity consisted of two sub-accounts: a money market account and a managed investment account invested in the Fund.

[8] Brooks testified that he did not see this form and that Frankfort represented to him that Frankfort was no longer involved with the Fund.

testified that Frankfort knew when Derakhshani opened and closed positions and was "always aware of how much money [was] in the account."

Frankfort decided to re-enter the securities business after a six-week period of being unregistered. On April 10, 2000, Frankfort executed a Uniform Application for Securities Industry Registration or Transfer Form ("Form U4") in order to associate with Brookstreet. Prior to associating with Brookstreet, Frankfort met with Brooks who told Frankfort that he would not be allowed to participate in the Fund unless, among other things, Brookstreet became a co-general partner, Brookstreet's counsel reviewed all offering documents, the Fund used an escrow account, and Brookstreet processed all Fund trades to enable the Firm to conduct a suitability and concentration review. Brooks reminded Frankfort soon after he associated that the Firm had not given Frankfort permission to engage in any private securities transactions. Brooks testified that Frankfort assured him when he joined the Firm that his involvement with the Fund was complete and that he no longer had any association with the Fund.

C. The Fund's Performance

On March 3, 2000, shortly before the stock market began to sharply decline in value, the Fund's first trade settled. By March 31, 2000, Frankfort had raised $3,180,427 for the Fund, but the Fund had already sustained a one-month loss of $1,108,782. The Fund's cumulative investment increased to $3,346,428 but its net value fell to $593,272 by April 30, 2000; thus, the Fund had lost more than 82 percent of its value. By May 31, 2000, the Fund had a net value of $382,214. The Fund's net value as of June 30, 2000, was $1,147,391, which included a $400,877 investment made by MC on June 20, 2000. The Fund's value as of July 30, 2000, had declined to $714,191 and included a $250,000 investment made by SW on July 7, 2000.[9]

In December 2000, AGL cancelled its contract with the Fund, and thereafter, AGL notified its customers that the Fund had been removed as an investment sub-account. The Fund ceased trading activity in January 2001. The Fund's net value on January 31, 2001, was $121,784. Derakhshani closed the Fund's Fidelity account in August 2001 and distributed the remaining proceeds to the limited partners.

[9] The Fund's decline in value was not due exclusively to market decline. On June 1, 2000, customer SA withdrew $15,000 of her investment in the Fund via AGL. On July 19, 2000, the Fund returned $450,000 to customer RS.

D. Customers SW and MC

1. SW

SW, a successful real estate executive, first met Frankfort sometime in April 2000. Frankfort solicited SW's investment in the Fund and gave him a PPM, but SW wanted first to utilize a put options strategy in his own account similar to the Fund's strategy before he committed to the $250,000 minimum investment. On April 26, 2000, SW executed Brookstreet new account documents. In May 2000, Frankfort began trading in SW's Brookstreet account. Frankfort testified that SW was pleased with the performance of his account and that the put options strategy that Frankfort had implemented for him had been successful. As a result, SW agreed to invest in the Fund.

On June 29, 2000, SW authorized Frankfort to wire transfer $250,000 from his Brookstreet account to the Fund. Frankfort admits that he did not disclose to SW the Fund's poor performance. Frankfort also did not provide prior written notice to Brookstreet regarding this transaction. Instead, the Firm learned of the wire transfer request from Brookstreet's operations manager who sought Brooks's approval. Brooks approved the transfer but emphasized to Frankfort that this was a one-time exception and that he was to have no further involvement with the Fund. Brookstreet transferred $250,000 from SW's Brookstreet account to the Fund on July 7, 2000.

In August 2001, SW received $22,918 when Derakhshani distributed the Fund's proceeds to the limited partners. SW later entered into a settlement with Brookstreet for $325,000, which was related to his Brookstreet account and investment in the Fund.

2. MC

MC is a wealthy investor. Her son, DC, has power of attorney for her investment decisions and may sign checks on her behalf. MC was one of JS's clients, and DC oversaw the portion of MC's assets that JS managed. On April 30, 2000, JS and Frankfort traveled to Chicago, Illinois, to attend a charity banquet organized by MC's family. In Chicago, JS arranged for Frankfort and DC to meet for breakfast on May 1, 2000. Frankfort was aware from JS that DC had previously purchased, on his mother's behalf, several variable annuities. During the breakfast meeting with DC, Frankfort solicited MC's investment in the Fund and proposed the Fund as an alterative to two of MC's then-current annuities that were underperforming. DC testified that Frankfort recommended investment in the Fund via the AGL annuity because it was better managed and had a better track record than the two underperforming annuities. DC testified that he was not aware that he was investing in a different strategy, specifically options trading, by investing in the Fund. DC asked Frankfort whether JS knew of the recommendation and Frankfort stated that he did. DC testified that Frankfort's discussion of the Fund encompassed approximately 15 minutes of the 45-minute breakfast meeting.

DC agreed, on MC's behalf, to invest in the Fund by making a variable annuity exchange and signed the forms to authorize the transactions. Frankfort never spoke with MC and never

told DC anything about the Fund's performance. On May 29, 2000, the proceeds of the annuity exchange were sent to AGL and deposited into MC's AGL money-market sub-account. On June 20, 2000, MC transferred approximately $400,877 from the AGL money market into the Fund.

In February 2001, MC received $40,926 from the Fund after AGL canceled its contract with the Fund. On August 20, 2003, MC reached a settlement with Frankfort and Brookstreet whereby each would pay MC $100,000 for her losses related to the Fund. MC also entered into an agreement with AGL in June 2004 pursuant to which AGL paid her $91,000.

V. Discussion

After a thorough review of the record, we affirm the Hearing Panel's findings of violation. We conclude that Frankfort engaged in fraudulent misconduct by failing to disclose to two customers that the Fund had realized substantial market losses, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and Conduct Rules 2120 and 2110.[10] We further find that Frankfort made an unsuitable recommendation to one customer in violation of Conduct Rules 2310 and 2110 and that he participated in private securities transactions involving the Fund without providing the requisite notice in violation of Conduct Rules 3040 and 2110. We discuss the violations in detail below.

A. Fraudulent Failure to Disclose Losses to Customers

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[11] 15 U.S.C. § 78j(b). SEC Rule 10b-5 makes it unlawful "[t]o employ any device, scheme, or artifice to defraud; to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[12] 17 C.F.R. § 240.10b-5. Liability for failing to disclose material information is

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[10] Conduct Rule 2110 requires that NASD members shall, in conducting their business, "observe high standards of commercial honor and just and equitable principles of trade." Conduct Rule 0115 makes all NASD rules, including Conduct Rule 2110, applicable to both NASD members and all persons associated with NASD members.

[11] The limited partnership interests were investment contracts and therefore securities under the Exchange Act. *See* 15 U.S.C. § 78c(a)(1).

[12] Conduct Rule 2120 is NASD's antifraud rule and is similar to Section 10(b) and Rule 10b-5. *Mkt. Regulation Comm. v. Shaughnessy*, Complaint No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (NBCC June 5, 1997), *aff'd*, 53 S.E.C. 692 (1998).

"premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Chiarella v. United States*, 445 U.S. 222, 230 (1980). A registered representative owes such a duty to his clients to disclose material information fully and completely when recommending a transaction. *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) ("[T]he broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale."); *Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc.*, 794 F.2d 198, 200 (5th Cir. 1986) ("The law imposes upon the broker the duty to disclose to the customer information that is material and relevant to the order."); *Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969); *SEC v. Hasho*, 784 F. Supp. 1059, 1106-07 (S.D.N.Y. 1992). A violation of the antifraud provisions requires a showing that the material omissions were made in connection with the purchase or sale of a security and were made with scienter.[13] *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996); *Dist. Bus. Conduct Comm. v. Euripides*, Complaint No. C9B950014, 1997 NASD Discip. LEXIS 45, at *18 (NBCC July 28, 1997). "[A]ny statement that is reasonably calculated to influence the average investor satisfies the 'in connection with' requirement of Rule 10b-5." *Hasho*, 784 F. Supp. at 1106.

It is undisputed that from its inception the Fund experienced significant monetary losses, and Frankfort did not disclose these losses to SW and MC when Frankfort solicited their investments or when he facilitated the transfer of their funds. Frankfort argues, however, that the Fund's early results "should be given little weight," and thus, the Fund's past performance was not a material fact that Frankfort was required to disclose.[14] Further, Frankfort argues that he was unaware of the Fund's losses. Frankfort also asserts that he acted without scienter.

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[13] In addition, there must also be proof that Frankfort used "any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange." 17 C.F.R. § 240.10b-5. Frankfort facilitated transactions in the Fund to customers through interstate telephone calls and the mails and therefore satisfied the interstate commerce requirement.

[14] Frankfort further contends that he was not required to disclose the Fund's performance because the investors were given a PPM, which suggested that investors should not rely upon oral statements made concerning the investment and which did not allow new investors to bear prior losses. The investors' receipt of a PPM, which did not disclose the Fund's losses, does not lessen Frankfort's liability for failing to disclose material facts. *See, e.g.*, *Robert A. Foster*, 51 S.E.C. 1211, 1213 n.2 (1994) ("Notwithstanding Foster's distribution of the prospectuses, he is liable for making untrue statements of material facts and omitting to state material facts . . . . As the Commission has long held, information contained in prospectuses 'furnishes the background against which the salesman's representations may be tested.'") (Order Instituting Proceedings, Making Findings and Imposing Sanctions) (*quoting Ross Secs., Inc.*, 41 S.E.C. 509, 510 (1963)); *cf. Larry Ira Klein*, 52 S.E.C. 1030, 1036 (1996) ("Klein's delivery of a prospectus to Towster does not excuse his failure to inform her fully of the risks of the investment package he proposed.").

1. Material Omissions

When a registered representative recommends a security to a customer, he must disclose "material adverse facts." *Richard H. Morrow*, 53 S.E.C. 772, 781 (1998). Whether information is material "depends on the significance the reasonable investor would place on the . . . information." *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988). Information is material "if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest] . . . and the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* at 231-32 (*quoting TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The SEC has previously held that the failure to disclose that a recommended security had incurred losses was important to a reasonable investor and thus a material fact that was required to be disclosed. *Dane S. Faber*, Exchange Act. Rel. No. 49216, 2004 SEC LEXIS 277, at *14-15 (Feb. 10, 2004). In this case, the Fund had experienced steady losses since its inception and had lost more than 82 percent of its value around the time that Frankfort solicited SW's and MC's investments. Accordingly, we find that reasonable investors would have considered the Fund's negative financial performance material to their investment decisions.

A registered representative is required to disclose material facts that are "reasonably ascertainable." *Hanly*, 415 F.2d at 597. Frankfort testified that he did not disclose the Fund's losses when he recommended the Fund to SW and MC because he was not aware of the losses.[15] The Hearing Panel, however, found that Frankfort was not credible when he denied knowing about the Fund's negative financial condition. The initial fact-finder's credibility determinations are entitled to considerable deference, which may only be overcome by substantial evidence. *Joseph S. Barbera*, 54 S.E.C. 967, 977 n.30 (2000); *see also Faber*, 2004 SEC LEXIS 277, at *17-18 (stressing that deference is given to initial decision maker's credibility determination "based on hearing the witnesses' testimony and observing their demeanor"). Because the substantial evidence necessary to reverse the Hearing Panel's findings of credibility is absent, we will not disturb the Hearing Panel's credibility findings here.

Moreover, we find that the Fund's losses were reasonably ascertainable to Frankfort. Frankfort admitted that he spoke with Derakhshani about the Fund's performance and various positions that Derakhshani was considering purchasing for the Fund, but he disputed that they discussed these matters frequently or in detail. Derakhshani testified that he and Frankfort routinely discussed the Fund's performance.[16] Frankfort admitted that during March through June 2000, he had a general idea of the positions held in the Fund, equity in the Fund, and the

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[15] Frankfort stipulated that he did not examine the Fund's trading account statement prior to recommending the Fund to SW and MC.

[16] Frankfort's knowledge that the Fund had experienced losses is further evidenced by his testimony that Derakhshani told him that he was "hedging the options with spreads" and Frankfort believed that this strategy would mitigate the losses.

Fund's buying power. He further admitted that he engaged in a parallel trading strategy and that he was losing money from this strategy at the end of March and April 2000: "I did a lot of the same positions and I lost a lot of money, personally, that we did in the fund." Moreover, in his investigative testimony, Frankfort testified that at the end of March 2000, the "markets were imploding on a daily basis" and that he knew that the Fund had lost money but that he did not know the specific numbers.

We determine that the Fund's negative performance was a material fact known to Frankfort that Frankfort should have disclosed to SW and MC when he solicited their investments.

2. Scienter

Frankfort also disputes that he acted with scienter when he failed to disclose the significant losses sustained by the Fund. We affirm the Hearing Panel's finding that Frankfort acted with the requisite scienter.

For purposes of securities fraud cases, scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter is established if a respondent acted intentionally or recklessly. *See Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 600 (7th Cir. 2006); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990) (en banc); *Irfan Mohammed Amanat*, Exchange Act Rel. No. 54708, 2006 SEC LEXIS 2545, at *34 (Nov. 3, 2006). Reckless conduct includes "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977); *see Meadows v. SEC*, 119 F.3d 1219, 1226 (5th Cir. 1997). Proof of scienter may be "a matter of inference from circumstantial evidence." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983).

We find, by a preponderance of the evidence, that Frankfort acted with scienter when he failed to disclose the Fund's losses. As discussed above, Frankfort had information about the Fund's losses and failed to disclose it to customers. In the case of a material omission, "scienter is satisfied where, as here, the [respondent] had actual knowledge of the material information." *Fenstermacher v. Philadelphia Nat'l Bank*, 493 F.2d 333, 340 (3d Cir. 1974); *see also Kenneth R. Ward*, Exchange Act Rel. No. 47535, 2003 SEC LEXIS 687, at *39 (Mar. 19, 2003) (finding scienter established when representative was aware of material information and failed to make appropriate disclosures to customers), *aff'd*, 75 Fed. Appx. 320 (5th Cir. 2003). Frankfort's failure to disclose the Fund's extensive losses presented a danger of misleading his customers.[17]

[17] Frankfort contends that despite the market's volatility during the spring and summer of 2000, he "still believed in a bull market." Frankfort's own belief that the market would rebound

[Footnote continued on next page]

For example, DC testified that had he known about the losses he would not have invested in the Fund on MC's behalf.

We conclude that Frankfort engaged in fraud, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Rules 2120 and 2110, when he failed to disclose the Fund's losses to solicited customers.[18]

B. Suitability

We also affirm the Hearing Panel's findings that Frankfort violated Conduct Rules 2310 and 2110 when he recommended that MC invest in the Fund, which was unsuitable.[19]

Conduct Rule 2310 provides that a representative in recommending a transaction to a customer "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 financial situation and needs." Compliance with the suitability rule requires a registered representative to "make a customer-specific determination of suitability and . . . tailor his recommendations to the customer's financial profile and investment objectives." *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168 (1989). As part of a broker's suitability obligation when recommending speculative investments, a broker must ensure that a customer understands the risks involved, in addition to determining that the recommendation is suitable for the customer. *Patrick G. Keel*, 51 S.E.C. 282, 284-85 (1993).

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is irrelevant. Personal belief in an investment does not excuse a failure to disclose material information to customers. *Faber*, 2004 SEC LEXIS 277, at *22.

[18] Count one of Enforcement's complaint also alleged that Frankfort violated the antifraud provisions of the federal securities laws and NASD rules by failing to disclose to customers SW and MC that the Fund intended to repurchase customer RS's limited partnership interest of $450,000 in contravention to the terms of the AGL PPM. Frankfort argued that RS's investment was to be held in a "suspension type of account," which could be returned to RS in full, until RS decided whether to make the investment. Customer RS did not testify at the hearing. The Hearing Panel therefore found that Enforcement failed to prove this allegation by a preponderance of the evidence. We affirm the finding.

[19] Enforcement alleged in its complaint that the Fund was unsuitable for all investors because of the Fund's negative financial performance and the market's downturn. The Hearing Panel disagreed with Enforcement's theory under these facts, and so do we. Enforcement further alleged that the Fund was unsuitable specifically for SW and MC. The Hearing Panel found that Enforcement failed to prove by a preponderance of the evidence that Frankfort's recommendation to SW was unsuitable. We affirm the Hearing Panel's finding.

We note the close connection between the first two violations in this case. Frankfort's failure to disclose the Fund's losses plays an important part in finding both a material omission and unsuitability. Although our focus in analyzing suitability is generally on whether a registered representative has reasonable grounds to make a recommendation, here we do not ignore the reality that Frankfort failed to disclose critical information about the Fund's losses. It is undisputed that Frankfort failed to disclose the Fund's losses when recommending that MC invest in the Fund. For Frankfort to understand MC's risk tolerance and to gauge whether his recommendation to invest in the Fund was suited for MC's needs, Frankfort was required to inform MC of the investment's demonstrated losses. In order for Frankfort, or any other registered representative, to have reasonable grounds for believing that an investment is suitable for a particular customer, he must disclose material information related to risk that he possesses about an investment when the failure to make such disclosures would otherwise violate the antifraud provisions of the securities laws.

DC testified that Frankfort did not describe the Fund's investment strategy to him, which Frankfort disputes. Frankfort testified that he told DC that the Fund would engage primarily in put options trading. DC stated that "[t]he sole characterization [Frankfort] made was these were better managers—better was a comparison to [MC's other annuity investments]—and with a good track record." DC thought that he was investing in an annuity with sub-accounts invested in a manner similar to the annuity that MC was invested in at the time but with "better managers, not with a different strategy." Specifically, DC believed that the Fund invested in stocks and not in options. The Hearing Panel determined that DC's testimony was more credible than Frankfort's version of the events. We will not disturb these findings.[20] *See Faber*, 2004 SEC LEXIS 277, at *17-18.

It is clear from DC's testimony that Frankfort gathered little, if any, information from DC regarding MC's investment objectives or risk tolerance when recommending the Fund. DC credibly testified that he did not complete the account application for the AGL annuity contained in the record, dated June 2, 2000, but he believed that he signed the form for his mother at the

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[20] Frankfort argues that DC's testimony was improper hearsay because MC was the actual investor and she did not testify at the hearing. Frankfort contends that MC should have been subject to cross examination. DC, however, had the power to sign checks for MC and make investment decisions on her behalf under a power of attorney, which is what occurred here. As the record reflects, DC was subject to extensive cross examination by Frankfort's counsel. DC's testimony was not improper. In any event, hearsay is allowable evidence in NASD proceedings. *See Kevin Lee Otto*, 54 S.E.C. 847, 854 (2000) ("The Commission has held repeatedly that hearsay is admissible in administrative proceedings and, in appropriate circumstances, may even constitute the sole basis for findings of fact."), *aff'd*, 253 F.3d 960 (7th Cir. 2001).

May 1, 2000 breakfast meeting.[21] That form lists MC's investment experience as "Extensive," her risk acceptance as "Above Average," and her investment objective as "Aggressive Growth." DC testified that he would not have made the selections marked on the form and would have "probably chosen 'Average' risk acceptance and 'Growth'" as the appropriate objective. Even if we credited the selection on the form that listed MC's objective as "Aggressive Growth," MC's investment in the Fund was inconsistent with that objective. As illustrated by DC's testimony, he understood that the Fund invested in stocks and not in options. The customer therefore was willing to tolerate the risks of a stock fund. We conclude that Frankfort's recommendation of the Fund was unsuitable because MC's investment objective was not speculation.

The parties stipulated that Frankfort provided DC with a PPM for the Fund and a subscription agreement. Frankfort contends that he provided the PPM to DC, encouraged him to read it, and that the PPM fully disclosed the risks of the investment. As we previously noted, however, the PPM did not disclose the large losses experienced by the Fund. More importantly, Frankfort's delivery of the PPM, as well as his encouragement for DC to read it, does not establish reasonable grounds for recommending an entirely speculative investment to his customer. *See Dep't of Enforcement v. Chase*, Complaint No. C8A990081, 2001 NASD Discip. LEXIS 30, at *17 (NAC Aug. 15, 2001), *aff'd*, Exchange Act Rel. No. 47476, 2003 SEC LEXIS 566 (Mar. 10, 2003). The rule requires that "[a] registered representative must be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks." *Chase*, 2003 SEC LEXIS 566, at *18; *see also Paul F. Wickswat*, 50 S.E.C. 785, 787 (1991) (finding that high-risk trading recommendations were at odds with the customer's stated objectives and representative was required to "obtain either a meaningful consent to the adoption of new investment objectives or an assent to a limited departure from [the customer's] general objectives"). Frankfort made no such assessment and failed to fulfill his suitability obligation. Indeed, Frankfort attempts to shift his own responsibility for determining suitability to JS who referred Frankfort to DC. Frankfort states in his brief that "[c]learly [JS], who had been working with [MC] for several years, was familiar with her investment objectives and risk tolerance. It was reasonable for Mr. Frankfort to believe that the fund was a suitable investment for [MC]." However, a registered representative who is making a recommendation to a customer cannot shift his responsibility for compliance with NASD rules related to that recommendation to others. *Justine Susan Fischer*, 53 S.E.C. 734, 741 & n.4 (1998) (holding that a broker has responsibility for his own actions and cannot blame others for his own failings).

Frankfort argues that because MC was financially able to lose her entire investment as evidenced by prior unprofitable investments, the Fund was not unsuitable for her. The fact that a customer is wealthy and can afford to lose the money invested does not provide a basis for recommending risky investments. *Arthur Joseph Lewis*, 50 S.E.C. 747, 749 (1991). "[S]uitablity relates to whether a specific securities transaction is appropriate for a particular

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[21] The account application contained in the record is from the PFG Distribution Co. PFG Inc. is the parent company of AGL. PFG Distribution Co. is a broker-dealer for variable life and annuity products, including the AGL annuity.

investor, not whether that investor can afford to lose the money invested." *Klein*, 52 S.E.C. at 1037-38.

We affirm the finding that Frankfort violated Conduct Rules 2310 and 2110 when he made a recommendation that was inconsistent with MC's risk tolerance and investment objectives.[22]

C. Private Securities Transactions

The Hearing Panel found that Frankfort engaged in private securities transactions, in violation of Conduct Rules 3040 and 2110, when he participated in the Fund transactions involving customers SW and MC without prior notification to his Firm in writing.

Conduct Rule 3040 requires an associated person to provide his employer with written notice of private securities transactions before the transactions take place.[23] *See* Conduct Rule 3040(b). The SEC has held that the written notice must describe in detail the proposed transactions and the associated person's proposed role in the transactions and state whether the associated person has received or may receive selling compensation in connection with the transactions. *Anthony H. Barkate*, Exchange Act Rel. No. 49542, 2004 SEC LEXIS 806, at *2 (Apr. 8, 2004), *aff'd*, 125 Fed. Appx. 892 (9th Cir. 2005).

Frankfort does not dispute that he engaged in the private securities transactions and stipulated that he did not provide prior written notice to Brookstreet before he provided SW and

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[22] A violation of NASD's suitability rules is also a violation of Conduct Rule 2110. *See Wendell D. Belden*, Exchange Act Rel. No. 47859, 2003 SEC LEXIS 1154, at *14 (May 14, 2003).

[23] If the associated person is compensated for the transactions, he must receive the firm's written permission before he engages in these transactions. *See* NASD Conduct Rule 3040(c). The parties stipulated that Frankfort did not receive compensation for the investments in the Fund.

MC with the Fund's PPM.[24] We affirm the Hearing Panel's finding that Frankfort engaged in private securities transactions in violation of Conduct Rules 3040 and 2110.[25]

VI. Sanctions

The Hearing Panel barred Frankfort for each violation. We affirm the bar for Frankfort's violation of the antifraud provisions of the federal securities laws and NASD's rules and affirm the imposition of a separate bar for making an unsuitable recommendation. For the reasons set forth below, we modify the sanctions for the private securities transactions.

A. Fraudulent Omissions

The NASD Sanction Guidelines ("Guidelines") for intentional or reckless misrepresentations or omissions of material facts under Conduct Rules 2120 and 2110 recommend a fine of $10,000 to $100,000, and a suspension of 10 business days to two years.[26] In an egregious case, the Guidelines recommend a bar.[27]

In determining the proper remedial sanction, the Guidelines for misrepresentations or omissions of material facts advise that adjudicators consider the "Principal Considerations in Determining Sanctions."[28] We find Frankfort's misconduct to be egregious. Frankfort's failure to disclose the Fund's negative financial performance to SW and MC was inexcusable.[29] As a result, SW and MC could not make informed investment decisions and truly assess whether an

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24 Frankfort argues that he did not believe that he was registered with Brookstreet when he solicited MC's investment on May 1, 2000. Under Article I, Section (cc)(1) of NASD's By-Laws, a person becomes associated with a member when he applies for registration or becomes registered. Frankfort executed a Form U4 for Brookstreet on April 10, 2000. NASD approved Frankfort's registration with Brookstreet on April 13, 2000. Accordingly, Frankfort was associated with Brookstreet in April 2000, before he solicited MC's investment in the Fund in May 2000, and was subject to Conduct Rule 3040's notice requirements.

25 A violation of Conduct Rule 3040 also constitutes a violation of Conduct Rule 2110. *Stephen J. Gluckman*, 54 S.E.C. 175, 185 (1999).

26 *NASD Sanction Guidelines* 93 (2006) (Misrepresentations or Material Omissions of Fact), http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf [hereinafter *Guidelines*].

27 *Id.*

28 *Id.* at 6-7 (Principal Considerations in Determining Sanctions).

29 *See id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

investment in the Fund was in their best interests, which ultimately caused them to suffer sizeable financial losses.[30] Frankfort totally disregarded his duty of fair dealing to his customers, including the obligation to disclose negative information about a recommended investment. *Dist. Bus. Conduct Comm. v. Goodman*, Complaint No. C9B960013, 1999 NASD Discip. LEXIS 34, at *33-34 (NAC Nov. 9, 1999). We also consider relevant in assessing the appropriate remedial sanctions that the Hearing Panel determined that Frankfort was not forthright and therefore not credible when he denied during the hearing that he knew of the Fund's negative financial performance when he solicited SW's and MC's investments.[31] Providing inaccurate information in an effort to minimize one's own responsibility serves to aggravate sanctions. We further find aggravating that Frankfort caused damage to Brookstreet as a result of his misconduct.[32] As we previously noted, the Firm has paid settlements to SW and MC in connection with the Fund transactions.

Frankfort's lack of understanding of his duty as a registered person to disclose all material facts to customers warrants significant sanctions. We believe that Frankfort's demonstrated indifference to the federal securities laws and NASD rules poses a serious risk to the investing public. We conclude that a bar is necessary to prevent Frankfort from inflicting similar harm to customers in the future. A bar will also serve to deter others from engaging in similar misconduct.

B. Unsuitable Recommendation

The Guidelines for unsuitable recommendations suggest a fine of $2,500 to $75,000.[33] In addition, the Guidelines suggest a suspension of 10 business days to one year, and in egregious cases, adjudicators should consider a suspension of up to two years or a bar.[34] We find that Frankfort's misconduct was egregious and that it warrants the bar imposed by the Hearing Panel. Frankfort withheld material information about the Fund's performance when making the recommendation thereby precluding a sufficient assessment of the customer's risk tolerance. Thus, Frankfort recommended a highly speculative investment without concern for the customer's understanding of the risk involved or the willingness to accept that risk. Moreover, the Hearing Panel found that Frankfort was not truthful when he testified that he explained the put options strategy to DC and that DC understood and agreed to that strategy.[35] We

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30 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 11).

31 *See Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 12).

32 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 11).

33 *Id.* at 99 (Suitability—Unsuitable Recommendations).

34 *Id.*

35 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 12).

acknowledge that Frankfort's misconduct involved only one transaction with one customer and that the misconduct resulted in no monetary gain.[36] Frankfort, however, intended to have a beneficial interest in the Fund by becoming a general partner in the future, and therefore he had the potential for monetary gain.[37] Frankfort solicited MC's unsuitable investment in the Fund at a time when the Fund had lost more than 80 percent of its value. Without an infusion of additional capital, the prospect of recouping the Fund's catastrophic losses and continuing the Fund as a viable entity diminished substantially.

Frankfort showed a dangerous lack of judgment that ignored obvious risks of losses to his customer and favored a struggling investment vehicle that he and Derakhshani had formed and launched. For Frankfort, the true interest of his customer became largely an afterthought. In addition, Frankfort's misconduct caused substantial losses to the customer.[38] To ensure that Frankfort causes no similar harm to the investing public in the future and to deter others in the industry from recommending unsuitable investments, we bar Frankfort from associating with any member firm in any capacity.

C. Private Securities Transactions

The Guidelines for private securities transactions provide that an adjudicator's first step in determining sanctions is to assess the quantitative extent of the transactions.[39] The Guidelines provide for a fine between $5,000 and $50,000 and the imposition of a suspension of up to one year when the dollar amount of the sales is between $500,000 and $1 million.[40] The Guidelines provide for a longer suspension or a bar when the amount of the sales exceeds $1 million.[41] Frankfort's transactions with SW and MC involving investments in the Fund totaled approximately $650,000. The Hearing Panel determined that a bar was appropriate. In light of the quantitative factors, we disagree with that finding.

The Guidelines also state that "[t]he presence of one or more mitigating or aggravating factors may either raise or lower the sanctions."[42] Thus, the Guidelines direct that we consider 10 additional principal considerations and the general considerations applicable to all violations

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36 *Id.* (Principal Considerations in Determining Sanctions, Nos. 17, 18).

37 *Id.* (Principal Consideration in Determining Sanctions, No. 17.)

38 *Id.* at 6-7 (Principal Considerations in Determining Sanctions, Nos. 11, 13).

39 *Id.* at 15 (Selling Away (Private Securities Transactions)).

40 *Id.*

41 *Id.*

42 *Id.*

in determining the appropriate sanction.[43] We find among these considerations both mitigating and aggravating factors. We find mitigating that the misconduct involved only two customers, the misconduct occurred over a short period of time, Frankfort did not create the impression that the Firm sanctioned the transactions, and he did not recruit other registered individuals to sell the Fund.[44] Contrary to the Hearing Panel, we also find somewhat mitigating that Brookstreet subsequently approved SW's transaction once the Firm learned of it. The degree of mitigation is lessened, however, because Frankfort did not provide requisite notice before the transaction commenced, and the Firm only learned of it through another Firm employee during the electronic funds transfer process.

Frankfort characterizes his selling away as "technical and inadvertent." We disagree and find that his misconduct was intentional.[45] Prior to becoming associated with Brookstreet, Frankfort met with Brooks who told him that he would not be allowed to participate in the Fund unless certain criteria were met. Upon joining Brookstreet, Brooks reminded Frankfort that the Firm had not given permission for any private securities transactions. Frankfort subsequently represented to Brooks that his activities with the Fund had concluded. We therefore find aggravating that Frankfort twice engaged in conduct that he knew that the Firm expressly prohibited, and in the case of MC, totally concealed the selling away activity from the Firm.[46] In addition, Frankfort sold away to SW who was a Brookstreet customer.[47] We find further aggravating that the Firm and the customers suffered damages as a result of Frankfort's misconduct, and the transactions violated the federal securities laws and NASD rules.[48]

Because of the aggravating factors present here, we fine Frankfort $50,000 and suspend him for one year.

VII. Conclusion

We affirm the Hearing Panel's findings that Frankfort made material omissions when he recommended the Fund to customers in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Conduct Rules 2120 and 2110; made an unsuitable recommendation in violation of Conduct Rules 2310 and 2110; and engaged in private securities transactions in violation of Conduct Rules 3040 and 2110. Accordingly, we bar Frankfort for the fraud

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[43] *Id.*

[44] *Id.* at 15-16.

[45] *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

[46] *See id.* at 16.

[47] *Id.*

[48] *Id.* at 6-7 (Principal Considerations in Determining Sanctions, Nos. 11, 15).

violation and separately bar him for the suitability violation. The bars are effective upon service of this decision. In light of the bars, we decline to impose the sanctions for the private securities transactions.[49]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

[49] We also have considered and reject without discussion all other arguments of the parties.