FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. DAVID JOSEPH ESCARCEGA (CRD No. 4367584), Respondent.	Disciplinary Proceeding No. 2012034936005 Hearing Officer - MJD **EXTENDED HEARING PANEL DECISION** February 29, 2016

Respondent David Joseph Escarcega made materially false and misleading statements to seven customers in connection with their purchase of securities, in willful violation of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010. Respondent also made unsuitable recommendations to 12 customers, in violation of NASD Rule 2310 and FINRA Rules 2111 and 2010. For these violations, he is barred from associating with any FINRA member firm in any capacity and fined $52,270, the amount he received in commissions.

Respondent caused his firm to make and preserve inaccurate books and records, in violation of FINRA Rules 4511 and 2010. In light of the bar, no additional sanctions are imposed for this violation.

The Department of Enforcement did not prove that Respondent distributed misleading sales literature, in violation of NASD Rule 2210(d)(1)(A) and FINRA Rule 2010. This charge is dismissed.

Respondent is also ordered to pay hearing costs.

Appearances

For the Complainant: Michael J. Rogal, Esq., and David M. Monachino, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Paul J. Roshka, Jr., Esq., and Craig M. Waugh, Esq.

DECISION

I. INTRODUCTION

Respondent David Joseph Escarcega willfully violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010 by making materially false and misleading statements to customers when he solicited them to invest in registered debt instruments called Renewable Secured Debentures ("Debentures") issued by GWG Holdings, Inc. ("GWG"). He also made unsuitable recommendations to 12 customers to invest in the Debentures, in violation of NASD Rule 2310 and FINRA Rules 2111 and 2010.

FINRA's Department of Enforcement filed the five-cause Complaint against Respondent on August 25, 2014.[1] The first cause charges that Escarcega knowingly or recklessly communicated false information in oral and written statements about the Debentures while soliciting customers. Enforcement alleges that Escarcega's misrepresentations constituted willful violations of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010.

The second cause alternatively charges that Escarcega failed to observe high standards of commercial honor and just and equitable principles of trade, in violation of FINRA Rule 2010, by making material misrepresentations in connection with the offer and sale of the Debentures to the same customers who are the subject of the first cause of action.

The third cause charges Escarcega with making unsuitable recommendations to customers, in violation of NASD Rule 2310 and FINRA Rules 2111 and 2010. Enforcement alleges that Escarcega did not have a reasonable basis to believe that his recommendations to invest in the Debentures were suitable based on the customers' overall investment profiles, including their age, annual income, net worth, and investment objectives, experience, and knowledge.

The fourth cause charges that Escarcega distributed a misleading GWG sales brochure about the Debentures to his customers, in violation of NASD Rule 2210(d)(1)(A) and FINRA Rule 2010. Enforcement claims the brochure was misleading because it incorrectly stated that the Debentures were secured by life insurance policies, without disclosing that the life insurance policies were not collateral for the Debentures and the investors' secured interests were subordinate to other creditors.

The fifth cause charges Escarcega with books and records violations of FINRA Rules 4511 and 2010 for falsely indicating on customer account documents that the funds they used to invest in the Debentures were not derived from a liquidation, redemption, or exchange of an

[1] The hearing was held July 27-29, 2015, in Phoenix, Arizona.

existing investment within the past 30 days. Enforcement also alleges that Escarcega overstated the net worth of a married couple on their account forms by approximately $300,000.

Escarcega denies that he made the allegedly fraudulent misstatements with the requisite scienter or with the intent to harm any customer. He admits that he described the Debentures as guaranteed, or used similar phrases, but that this was inadvertent and he meant to communicate that the Debentures had "fixed" or "stated" rates of return. He claims that he fully disclosed the risks of the Debentures to his customers, that the risks were also contained in the Prospectus and other written materials that he provided to them, and that he had a reasonable basis for his recommendations. Further, he states that the customers had full knowledge of all the material facts concerning the Debentures. Escarcega notes that the Debentures are performing as represented by GWG and customers have incurred no losses so far. Escarcega asserts that he reasonably relied on his firm's compliance and supervisory personnel's review and approval of his customers' account documents and transactions and GWG's written materials.

II. SUMMARY OF FINDINGS

The Extended Hearing Panel finds that Enforcement established by a preponderance of the evidence that Escarcega intentionally or recklessly made materially false misrepresentations or omissions in connection with the sales of the Debentures to seven customers, in willful violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010. Escarcega had no basis to tell his customers that the Debentures were guaranteed or safe when the Prospectus was replete with warnings about their high risk as an investment. Because the Panel determines that Escarcega fraudulently solicited customers to invest in the Debentures, we dismiss the alternative second cause of action that alleges a violation only of FINRA Rule 2010.

The Panel also finds that Escarcega made unsuitable recommendations to 12 customers by failing to take into account their overall financial situations and needs, as alleged in cause three. The Debentures were high-risk securities suitable only for investors with sufficient financial resources who could afford to lose their entire investment. The 12 customers were not such investors. By making the unsuitable recommendations, Escarcega violated NASD Rule 2310 and FINRA Rules 2111 and 2010.

Because Escarcega's fraudulent misrepresentations and unsuitable recommendations are related, the Panel imposes a unitary sanction. The Panel determines that Escarcega's misconduct is egregious and bars him in all capacities from associating with any member firm and fines him $52,270, the amount he received in commissions from GWG for his sales of the Debentures.

The Panel finds that Escarcega violated FINRA Rules 4511 and 2010 by causing his firm to make and preserve incorrect books and records. He failed to disclose on a customer's account documents that the purchase of more than $100,000 in Debentures was a product switch. The Panel also finds that Escarcega generated account forms that falsely inflated a couple's net worth. For this violation, the Panel would suspend Escarcega in all capacities for ten business

days and fine him $5,000. However, we impose no additional sanctions for this violation in light of the bar for the fraudulent misrepresentations and unsuitable recommendations.

Enforcement did not establish by a preponderance of the evidence that Escarcega violated FINRA's advertising rules by distributing to his customers an allegedly misleading sales brochure about the Debentures. We therefore dismiss the fourth cause of action.

III. FINDINGS OF FACTS

A. Respondent David Joseph Escarcega

Escarcega entered the securities industry in 2001. He was registered with five FINRA member firms as a General Securities Representative and Investment Company and Variable Contracts Products Representative before he joined Center Street Securities, Inc. in March 2010.[2] He is an independent contractor and works out of an office at his residence near Phoenix, Arizona. Escarcega's client base consists primarily of retirees.[3]

Escarcega conducts his securities business through Strategic Financial Partners LLC, a company he formed in early 2010.[4] Escarcega describes Strategic Financial as "a full-service company specializing in retirement planning and estate preservation."[5] In advertisements for the GWG Debentures that he distributed to potential investors, Escarcega falsely claimed that Strategic Financial was a registered investment advisor[6] and that his company had three branch offices in California and Nevada, in addition to the one at his residence in Arizona.[7]

B. GWG and the Renewable Secured Debentures

During 2012, FINRA learned of an unsolicited letter that was distributed to potential customers asking them to consider investing in GWG Debentures. In late 2012, Enforcement opened an investigation into the sales of the Debentures by member firms. Center Street was one of the broker-dealers selling the Debentures. Enforcement learned that Escarcega had sold the second most Debentures of any Center Street broker. In April 2013, Enforcement conducted an on-site examination of Escarcega's office.[8]

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[2] CX-1, at 5-6, 10.

[3] Parties' Stipulation of Undisputed Facts ("Stip.") ¶ 10; Tr. 280-81, 323.

[4] CX-2, at 7.

[5] CX-10, at 7; *see also* CX-7, at 1 (Strategic Financial "provid[es] retirement and estate conservation strategies.").

[6] CX-12, at 1. Escarcega testified that the statement that Strategic Financial was a registered investment advisor was "not accurate." Tr. 284.

[7] CX-7, at 3; CX-10, at 7. Escarcega admitted at the hearing that Strategic Financial did not have offices in California and Nevada. Tr. 289.

[8] Tr. 200-06.

GWG was founded in 2006. It describes itself as a licensed viatical settlement provider.[9] Through subsidiaries, the company buys life insurance policies on the secondary market that are sold by insureds at a discount from the face value of the insurance benefit. Once GWG buys a policy, it continues to pay the policy premiums so it can collect the insurance benefit on the death of the insured. GWG's objective is to earn more in proceeds from the insurance benefits payable when an insured dies than it costs GWG to purchase, finance, and service the policies to maturity.[10]

The company borrows money to buy and service life insurance policies. GWG finances its "business almost entirely through the issuance of debt."[11] In early 2012, GWG began offering the Debentures to raise more than $230 million in net proceeds (after paying offering expenses) to pay operating expenses, buy more life insurance policies, pay premiums on existing policies it owned, make periodic interest payments to lenders and pay them their principal at maturity.[12] The Debentures had maturity dates ranging from six months to seven years. The Debentures paid investors interest ranging from 4.75 percent per year for a six-month Debenture to 9.5 percent per year for a seven-year Debenture. GWG required a minimum investment of $25,000. Investors could purchase additional amounts in increments of $1,000.[13]

Escarcega first heard of GWG during a prior private offering of its securities. When GWG began offering the Debentures, in early 2012, it contacted Center Street about selling them. Escarcega met with "numerous" GWG representatives to learn about the Debentures, and "was informed directly from GWG as to the details" of the Debenture offering.[14] Center Street conducted one-on-one training sessions with brokers interested in soliciting customers to buy the Debentures. Representatives from GWG also attended Center Street conferences and discussed the Debentures with firm registered representatives.[15] In 2012, Escarcega traveled to GWG's

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[9] CX-13, at 12-13; CX-14, at 14. Two Prospectuses covered the relevant period of March 2012 to January 2013. The second Prospectus, dated May 15, 2012 (CX-14), contained substantive provisions that were identical to those in the first Prospectus dated January 31, 2012. Also in the record is Prospectus Supplement No. 2 to the May 2012 Prospectus, dated August 14, 2012 (RX-4).

See definition and discussion of viatical settlements at www.sec.gov/answers/viaticalsettle.htm (stating that viatical settlements "can be risky investments. For these reasons, you should exercise caution and thoroughly investigate *before* you consider investing in a viatical settlement." (Emphasis in original.)) (last visited Feb. 24, 2016).

[10] GWG purchases the life insurance policies through its subsidiary, GWG Life Settlements LLC. Most of the policies are owned by GWG DLP Funding II, LLC, a subsidiary of GWG Life Settlements. CX-13, at 9-10; CX-14, at 9-10.

[11] CX-13, at 12; CX-14, at 12.

[12] CX-13, at 32-33; CX-14, at 35-36.

[13] CX-13, at 3, 7; CX-14, at 2, 7; Stip. ¶ 8.

[14] CX-40, at 1.

[15] CX-41, at 6.

offices in Minnesota to attend two days of "product training" about the Debentures. He also participated in an online GWG webinar about the Debentures.[16]

Approximately one-fourth of Escarcega's customers, or about 35 customers, invested in the Debentures.[17] The commission on the sale of the Debentures was as high as five percent, in the case of the seven-year Debentures; Escarcega received 90 percent of the commissions paid by GWG, and Center Street received the balance.[18] Escarcega earned $52,270 in commissions from his sales to the customers that are the subject of the Complaint.[19]

Escarcega sold the Debentures to his customers from March 2012 to January 2013. The Prospectus detailed the suitability standards for investors and also devotes 13 pages to describing specific risks of investing in the Debentures. The Prospectus stated that the Debentures "are suitable only as a long-term investment for persons of adequate financial means who have no need for liquidity in this investment."[20] GWG cautioned that it did not expect there to be a public market for the Debentures, "which means that it may be difficult or impossible . . . to resell the debentures."[21] An investor cannot get his principal back before maturity unless he becomes disabled, files for bankruptcy, or dies. Otherwise, an investor is subject to a six percent redemption fee in the event that GWG agrees to redeem a Debenture, although it is under no obligation to buy them back.[22]

Ten of Escarcega's customers who bought the Debentures on his recommendation were Arizona residents.[23] Pursuant to state law, the Prospectus contained specific minimum financial requirements for Arizona residents. According to the Prospectus, to qualify to invest in the Debentures, Arizona residents were required to have either:

> (i) a minimum of $150,000 (or $200,000 when combined with a spouse) in gross income during the prior year and a reasonable expectation that the investor will have at least such income in the current year, or (ii) a minimum net worth of $350,000 (or $400,000 when combined with a spouse), exclusive of home, home furnishings and automobiles, with the investment in debentures offered hereby not

[16] Tr. 300, 303.

[17] Tr. 314. The parties stipulated that Escarcega had "approximately" 130 customers during the relevant period and that "more than twenty" of them invested in the Debentures. Stip. ¶ 12.

[18] Tr. 316.

[19] CX-42.

[20] CX-13, at 6; CX-14, at 6.

[21] CX-13, at 6; CX-14, at 6.

[22] CX-13, at 29; CX-14, at 31.

[23] Stip. ¶¶ 17, 21, 25, 29, 45, 49, 53, 61.

exceeding 10% of the net worth of the investor (together with spouse, if applicable).[24]

On Escarcega's recommendation, six Arizona customers invested more than ten percent of their net worth in the Debentures. GWG reimbursed these customers a total of nearly $400,000, representing that portion of their investments that exceeded ten percent of their stated net worth on account documents.[25]

Separate from the Arizona ten percent concentration limit contained in the Prospectus, Center Street also had an unwritten policy that limited customers to placing no more than ten percent of their net worth in alternative investments to "diversify the risk on the investment concentration."[26] The firm and Escarcega considered the Debentures to be alternative investments. At the time he solicited customers, Escarcega knew his employer had this unwritten rule.[27]

Eight of Escarcega's customers who invested in the Debentures were residents of California and Washington. According to the Prospectus, general suitability standards applied for residents of those states. To qualify to invest in the Debentures, a California or Washington investor needs a net worth of $70,000 (excluding home, furnishings, and automobiles) and annual income of $70,000, or a net worth (excluding home, furnishings, and automobiles) of at least $250,000.[28] The Prospectus cautioned that satisfying the minimum suitability requirements that GWG established for potential investors "will not necessarily mean that the debentures are a suitable investment for a prospective investor."[29]

The Risk Factors section of the Prospectus warned that "an investment in the Debentures involves a high degree of risk," and that if any of the identified "risks materialize or occur, the value of our debentures could decline and could cause you to lose part or all of your investment."[30] The January 2012 Prospectus discussed 30 separate risk factors in detail. These

[24] CX-13, at 7; CX-14, at 6; RX-4, at 3.

[25] CX-43 (compare amounts in "principal investment" column with "reduction amount (per investment)" column for Arizona customers JB, DB, RL, NH, SC, and PB).

[26] Tr. 62.

[27] Tr. 313-14.

[28] CX-13, at 6; CX-14, at 6; RX-4, at 2. Prospectus Supplement No. 2 to the Prospectus dated May 15, 2012, added the requirement that Washington residents must be "accredited investors" as the term is defined in Rule 501(a) of the Securities Act of 1933. RX-4, at 3. Two customers, JS and MS, a married couple, were Washington residents who purchased two Debentures totaling $383,014 after the effective date of Prospectus Supplement No. 2. Stip. ¶¶ 66-69. Even though no evidence was presented as to whether JS and MS were accredited investors, as discussed below, the Panel finds that the Debentures were unsuitable for them.

[29] CX-13, at 7; CX-14, at 7; RX-4, at 4.

[30] CX-13, at 19; CX-14, at 22. Similar warnings were contained in Prospectus Supplement No. 2. RX-4, at 1.

were repeated in substantially the same form in the May 15, 2012 Prospectus, which added a new risk factor to the list.[31] The more relevant and significant risks include the following:

- GWG had a limited operating history and had never made a profit. In 2009 and 2010, it had combined losses exceeding $5 million.[32] (The May 2012 Prospectus disclosed that GWG had a net loss of over $2.8 million for the year ending December 31, 2011.[33])

- Because GWG relied primarily on debt to finance its operations, an inability to continue to borrow could affect its business.[34]

- The Debentures are illiquid so investors would be unable to quickly re-sell their Debentures in the event they needed access to principal.[35]

- Changes in actuarial assumptions concerning the life expectancy of insureds could affect GWG's cash flow and its ability to service payments on the Debentures.[36]

- Holders of Debentures likely could not recover their principal in the event of a default because the Debentures are subordinate to all other senior debt GWG has incurred.[37]

C. Escarcega's Marketing Practices

Most of Escarcega's customers were retired. One way he solicited new business was through a direct mail firm he retained to send invitations to potential customers to attend free investment seminars he hosted in Arizona and California.[38] Escarcega sometimes included with the invitations a flyer advertising the Debentures prepared by GWG and reviewed by FINRA.[39] He conducted his seminars about once every month. At about half of the seminars, Escarcega

[31] CX-14, at 33. The new risk factor relates to GWG's status as an "emerging growth company" as defined in the recently enacted JOBS Act of 2012. Under the Act, an "emerging growth company" is entitled to exemptions from certain accounting and reporting requirements, which the Prospectus acknowledged could make the Debentures less attractive should GWG rely on the exemptions. The May Prospectus included a separate section discussing the implications of GWG being an "emerging growth company" under the JOBS Act. CX-14, at 12-13, 33. Prospectus Supplement No. 2 summarized the risk factors contained in the Prospectus. RX-4, at 4.

[32] CX-13, at 20.

[33] CX-14, at 22.

[34] CX-13, at 21; CX-14, at 23.

[35] CX-13, at 6; CX-14, at 6.

[36] CX-13, at 25; CX-14, at 27.

[37] CX-13, at 27-28; CX-14, at 29-30.

[38] Stip. ¶ 11.

[39] CX-10, at 4-5; CX-11, at 4-5; Tr. 327.

presented information on the GWG Debentures.[40] Escarcega titled his seminars "Finding Safety in an Unstable Economy,"[41] which carried the subtitle, "Isn't It Time to *Finally* Have Safety & Growth in 'Your' Retirement Strategies?" [Emphasis and quotation marks in original.] If attendees were interested in following up with Escarcega, they could fill out a Strategic Financial questionnaire. The questionnaire asked attendees to give Escarcega their net worth, age, and health. Attendees could also use the form to schedule a meeting with Escarcega.

At the seminars, Escarcega used a PowerPoint presentation prepared by GWG to discuss the Debentures.[42] He also handed out information about the Debentures along with materials about other investment products. Escarcega provided a GWG sales brochure, the Prospectus and supplements, and a subscription agreement, as well as a sample interest rate sheet and the PowerPoint presentation to persons interested in the Debentures. These documents also were emailed as a so-called e-Kit produced by GWG.[43]

Because the Debentures would be held directly by the customer, rather than through Center Street's clearing firm, each investor had to submit a new account application, regardless of whether the investor was a new or existing client. Escarcega personally filled out the information on all of the account forms that each customer submitted to Center Street in connection with a purchase of Debentures. These forms include the customer account application and Center Street's "Alternative Investment (Non-Reg D) Suitability Verification and Investor Acknowledgment" form ("suitability verification form").[44]

In the event a client was selling an existing investment within the preceding 30 days to acquire the funds to buy the Debentures, Escarcega had to submit to Center Street a switch letter. Some customers did not sell an existing investment within the preceding 30 days, and so did not require the submission of a switch letter when they bought Debentures.[45] Escarcega made his written misrepresentations in the course of filling out a customer's switch letter. In the presence of each of the six customers to whom he made written misrepresentations, Escarcega wrote answers to three questions posed on the switch letter asking to (i) describe the reasons for the change in investment product, (ii) compare the features of the customer's current investment with those of the Debentures, and (iii) identify other investments he discussed with the customer. His customers then reviewed what he wrote and signed the switch letter.[46]

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[40] Tr. 323-24.

[41] CX-10, at 3; CX-11, at 3.

[42] Tr. 330.

[43] Tr. 380-81; CX-15.

[44] Stip. ¶ 13.

[45] Tr. 367 (Escarcega testifying that, for example, customers WJ and SM did not submit a switch letter because their sale of an existing investment was made more than 30 days before they bought the Debentures).

[46] Tr. 342 (Escarcega testifying that he and the customer filled out the switch letter together). The parties stipulated that Escarcega "filled out the information" on the customer switch letters and "had his clients execute that form" before they bought the Debentures. Stip. ¶ 14.

IV. CONCLUSIONS OF LAW

A. Escarcega Made Fraudulent Statements to Customers About the Debentures

Escarcega willfully violated Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010 by making materially false and misleading statements to seven customers who invested in the Debentures. He made oral misrepresentations to one customer and written misrepresentations to six customers.

Section 10(b) of the Exchange Act and Rule 10b-5 prohibit fraudulent and deceptive acts and practices in connection with the purchase or sale of a security. Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o 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." Rule 10b-5 prohibits a person from, directly or indirectly, (a) employing any device, scheme or artifice to defraud, (b) making an untrue statement of material fact or omitting a material fact necessary to make a statement not misleading, and (c) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon a person. To establish a violation under these provisions requires proof that Escarcega (a) made a material misrepresentation or omission, or used a fraudulent device, (b) in connection with the purchase or sale of a security, and (c) acted with scienter.[47] Escarcega does not dispute that the Debentures are securities and that his conduct occurred in connection with the purchase or sale of a security. Accordingly, we address below only the materiality and scienter elements.[48]

1. Escarcega Made Material Misrepresentations or Omissions

A fact is considered to be material within the meaning of Rule 10b-5 if there is a substantial likelihood that a reasonable investor would view the fact as significantly altering the

[47] *SEC v. First Jersey Sec., Inc*., 101 F.3d 1450, 1466 (2d Cir. 1996). It is not disputed that the Debentures are securities. Section 2(1) of the Securities Act of 1933 and Section 3(a)(10) of the Exchange Act define a "security" to include a debenture. Stip. ¶ 8; CX-13, at 2 (January 31, 2012 Prospectus describing Debentures as securities). Violations of Section 10(b) of the Exchange Act and Rule 10b-5 must also involve the use or the means or instrumentalities of interstate commerce, or the mails, or any facility of any national security exchange. Escarcega does not contest that the element of interstate commerce is met. He admitted that he met customers outside of Arizona and that he mailed account documents from Arizona to Center Street in Tennessee. Answer ("Ans.") ¶¶ 23, 48. Furthermore, he used a direct mail firm to send invitations to potential clients to attend his seminars in California and his customers' account documentation was submitted to GWG's office in Minnesota. Stip. ¶¶ 11, 16. Eight customers (NJ, RJ, CM, NZ, WJ, SM, JS, and NS) who invested in the Debentures resided in California and Washington. Stip. ¶¶ 33, 37, 41, 57, 66.

[48] The Complaint also alleges violations of FINRA Rules 2020 and 2010. Rule 2020 is FINRA's anti-fraud rule and is broader than Section 10(b) of the Exchange Act and Rule 10b-5. *See Dep't of Enforcement v. Fillet*, No. 2008011762801, 2013 FINRA Discip. LEXIS 26, at *38 (NAC Oct. 2, 2013) (Rule 2020 "captures a broader range of activity than Rule 10b-5(b)"), *aff'd in relevant part*, Exchange Act Release No. 75054, 2015 SEC LEXIS 2142 (May 27, 2015). Misconduct that violates U.S. Securities and Exchange Commission ("SEC") or FINRA rules is inconsistent with high standards of commercial honor and just and equitable principles of trade and violates Rule 2010. *Joseph Abbondante*, 58 S.E.C. 1082, 1103 (2006), *aff'd,* 209 F. App'x 6 (2d Cir. 2006).

total mix of information made available.[49] Material facts include those facts that may affect the desire of investors to buy, sell, or hold a company's security.[50] The standard for materiality "is objective –[ ]it asks what a reasonable investor would consider material under the circumstances."[51] Statements about "whether an investor is guaranteed a predetermined rate of return or whether the return on an investment may fluctuate are material."[52]

Escarcega's misrepresentations were intended to induce customers to purchase the Debentures. A reasonable investor would have found Escarcega's assurances about the Debentures important in deciding to purchase them. He told his customers that the Debentures were safe or low risk, offered a guaranteed rate of return, and conserved principal. In light of the extensive risks described in detail in the Prospectus, Escarcega did not have an objectively reasonable basis to make such statements.[53]

Escarcega made material misrepresentations about the GWG Debentures to seven customers. He made oral misrepresentations about the Debentures' safety and risk to customer JB and written misrepresentations to customers CM, NZ, NJ, RJ, RE, and MD, telling them that their investments were guaranteed or safe. JB testified about the misrepresentations Escarcega made to him. The written misrepresentations Escarcega made to the other six customers were recorded on their switch letters that he filled out in their presence and which he acknowledges they read.[54]

Enforcement also contends that Escarcega made similar oral misrepresentations to customer RL. However, RL did not testify and there was insufficient other evidence to support this claim.[55] The Hearing Panel therefore dismisses the fraud charge regarding customer RL.

a. Escarcega Made Oral Misrepresentations to Customer JB

Because he was the only customer who testified at the hearing, we first discuss customer JB. JB and Escarcega's testimony on key issues were in direct conflict with one another. Although JB had difficulty accurately recalling certain facts and events, the Panel determines

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[49] *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988).

[50] *SEC v. Hasho*, 784 F. Supp. 1059, 1108 (S.D.N.Y. 1992) (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

[51] *Robert Tretiak*, 56 S.E.C. 209, 222 (2003).

[52] *Dep't of Enforcement v. Apgar*, No. C9B020046, 2004 NASD Discip. LEXIS 9, *13-14 (NAC May 18, 2004).

[53] *Dep't of Enforcement v. Meyers*, No. C3A040023, 2007 NASD Discip. LEXIS 4, *33 (NAC Jan. 23, 2007) (guarantees and predictions of substantial price rises must have a reasonable basis and without a reasonable basis, such guarantees and predictions constitute material misrepresentations).

[54] Tr. 342, 366-67, 423-35.

[55] Enforcement's investigator testified that RL told him that Escarcega described the Debentures as a "very low risk investment" and that RL could not "remember too much of the specifics about" the Debentures. Tr. 237. The Panel finds that this testimony does not constitute sufficient evidence to find that Escarcega made oral misrepresentations to RL.

that when testifying on the same key material issues, JB's testimony was more credible than Escarcega's testimony. The Panel accordingly finds, after weighing all the evidence relating to JB and his wife's investment in the Debentures, that Escarcega made materially false and misleading oral statements to JB to induce them to invest in the Debentures.

Customers JB and DB were Arizona residents, retired, and 77 and 74 years of age. JB had a high school education and received vocational training at a beauty school and was a professional hairdresser.[56] In April 2012, the couple purchased a seven-year term Debenture for $117,000 for their joint account.[57]

JB and his wife were referred to Escarcega by one of his partners at Strategic Financial.[58] They attended one of Escarcega's seminars during which Escarcega pitched the Debentures. After the seminar, Escarcega met with JB and DB at their home to discuss the Debentures.[59] JB testified that, "Whatever [Escarcega] said [at the seminar] was interesting enough to come over to my house and explain his product and we thought it sounded good."[60] According to JB, Escarcega told JB and DB the Debentures "will be safe" and he presented no other investment options to them.[61] He explained that they would earn $900 per month for seven years and their principal would be returned at the end of the period. Escarcega acknowledged that the annuity JB owned had an early withdrawal penalty if he liquidated it to acquire the funds to buy the Debentures. According to JB's testimony, Escarcega told JB that he and his wife would "make up the money on the other end."[62] JB testified that Escarcega told him that the Debentures paid a "fixed guaranteed rate of return without fear of losing principal."[63] JB testified that if he had known that the Debentures were not safe he "probably never would have invested in it" because incurring the $17,000 surrender charge for liquidating the annuity "doesn't s[i]t well with me and my wife. We don't do things like that. We can't afford things like that," and he "worked too hard for my money to throw away $17,000."[64] JB said he and his wife are "chicken" and they "don't take risks. . . . My risk and tolerance or whatever is nil."[65]

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[56] Tr. 124.

[57] Stip. ¶¶ 17-20. JB and DB originally purchased a seven-year Debenture for $117,000 but in August 2012 they requested a distribution of $12,500 from GWG. GWG issued a new Debenture bearing the original issue date in the amount of $104,500. The parties accordingly stipulated that JB and DB invested in a $104,500 Debenture. Stip. ¶ 19; CX-19, at 1-3, 23, 25.

[58] Tr. 129-30; CX-21, at 2.

[59] Tr. 132, 382-83. Escarcega's calendar reflects meetings with JB and DB on March 7 and March 20, 2012. RX-7, at 3.

[60] Tr. 130.

[61] Tr. 132.

[62] Tr. 134.

[63] Tr. 156.

[64] Tr. 134, 141.

[65] Tr. 127.

Like the other customers who invested in the Debentures through Escarcega, JB and DB signed a Subscription Agreement, a Center Street account application, and a suitability verification form. JB testified that Escarcega filled out the documents, including checking the boxes for investment objective and experience, and he and his wife signed them in Escarcega's presence.[66]

The couple's suitability verification form for the purchase of $117,000 in Debentures states their annual income was $60,000 and total net worth $635,000.[67] The $117,000 investment in Debentures constituted over 18 percent of JB and DB's $635,000 net worth, as Escarcega calculated on the couple's suitability verification form. To buy the Debentures, JB liquidated a fixed annuity with a then-current value of $126,139.90. After applying an adjustment for interest earned to date of $8,677.73 and deducting surrender charges of $17,028.89, JB received $117,788.74 in net proceeds via a wire transfer.[68]

According to the suitability verification form, JB and DB's stated net worth of $635,000 purportedly included $100,000 in mutual funds, $125,000 in bonds, a life insurance policy with a cash value of $30,000, fixed annuities of $130,000, a recreational vehicle (RV) worth $100,000, and real estate valued at $150,000. At the hearing, JB credibly contested both the annual income and net worth figures that Escarcega recorded on their account documents. He acknowledged having signed the account documents, but stated that Escarcega "did all the paperwork. We just signed our names."[69] He testified that they paid $100,000 for their RV in 2005 and that it was likely worth less than half that amount by 2012.[70] JB testified that at the time of the investment they did not own $100,000 in mutual funds, bonds totaling $125,000, or real estate worth $150,000, as set forth on the suitability verification form.[71] Removing these three amounts, and reducing the value of the RV by half, JB and DB's actual total net worth was approximately $210,000.[72]

Customer JB testified that his family's annual income was between $20,000 and $25,000, not $60,000 as Escarcega recorded on the suitability verification form. The couple's 2012 joint

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[66] Tr. 144-45.

[67] CX-19, at 14-16.

[68] CX-20, at 2.

[69] Tr. 145.

[70] Tr. 151.

[71] Tr. 150-52. JB said he "might have had some [mutual funds] years ago with a bank," but not when he invested in the Debentures. Tr. 148. JB and DB reverse mortgaged their residence, according to JB, and owned no real estate at the time of the Debenture purchase. JB recalled that the proceeds of the reverse mortgage were invested in the annuity he later liquidated to buy the Debentures. Tr. 152, 173.

[72] Enforcement alleged in the Complaint ("Compl."), ¶¶ 44, 64, that Escarcega inflated the couple's net worth by approximately $300,000, resulting in an actual net worth of approximately $335,000. Based on the evidence presented at the hearing, Enforcement revised its estimate and claims JB and DB's true net worth was $210,000; Escarcega accordingly overstated the couple's net worth by more than $400,000. Enforcement's Post-Hearing Brief, at 25-26.

federal tax return shows that they received Social Security benefits of $21,826 and other wages and salaries of $4,481.[73]

Escarcega recorded that JB and DB's investment objective was "Balanced/Conservative Growth" and that they had "Average" investment experience.[74] JB testified that the description of the couple's overall investment experience is false because he "never said it was average," and their experience in fact was "[n]othing, nil."[75]

On their account application form, Escarcege described JB and DB's experience with alternative investment products as "Average." JB testified he and his wife did not have "Average" knowledge or experience with such products.[76] Escarcega testified that he characterized JB and DB's knowledge and experience with alternative investments as "Average" only because he believed they understood the Debentures after he explained to them how the product worked. Escarcega marked other customer account forms as having "Average" knowledge and experience with alternative investments for the same reason—he had just explained the characteristics of the Debentures to them.[77]

Escarcega points to alleged discrepancies in JB's testimony as evidence that Escarcega's version of events is more accurate. The Panel finds that any such discrepancies are collateral issues and not material to its overall finding that Escarcega made misrepresentations to JB and DB about the Debentures. Escarcega points out, for example, that JB incorrectly testified that he and his wife elected to receive monthly interest payments of $900 from the Debentures and that they needed the money for living expenses, when in reality they elected to have interest earned reinvested at the end of each year.[78] He states that JB and DB could not have needed the $900 in monthly interest payments because they elected instead to roll over the interest at the end of each year. Within six months of investing in the Debentures, however, JB and DB requested a distribution of $12,500, evidencing their need for the funds they used to buy the Debentures.[79]

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[73] The tax return also shows income from "pensions and annuities" totaling $134,905, of which only a portion—$27,876—was taxable. CX-20, at 3-6. Aside from JB's annuity, no direct evidence was presented concerning the source of the pension and annuity income. Escarcega testified he was told by the couple that DB was a retired teacher and received a pension, which could explain a portion of the $134,905 amount. Tr. 484. Based on the evidence presented, the remainder of the income, the Panel determines, is from the annuity liquidation.

[74] CX-19, at 10-16.

[75] Tr. 146.

[76] Tr. 146, 148.

[77] Tr. 453-54.

[78] Tr. 167-68; Escarcega Post-Hearing Brief, at 5-6; CX-19, at 3 (for the seven-year $104,500 Debenture, showing $10,699.64—equal to $891.58 per month—in interest paid after one year). A Debenture in the amount of $117,000, paying 9.5 percent interest, would generate $11,115 per year, or approximately $926 per month.

[79] CX-19, at 25.

Escarcega also testified that he advised the couple not to surrender JB's annuity to buy the Debentures because of the costs of effecting the investment switch.[80] But Escarcega made no written record of this claim, and there is no other evidence that he gave this advice. Also, the Panel does not find it credible that an experienced broker like Escarcega would proceed with switching customers from a safe investment involving more than $100,000 if he had urged his clients against doing so.[81] For these reasons, the Extended Hearing Panel rejects Escarcega's contention.

JB credibly testified that he would not have invested in the Debentures had he known of their high-risk nature. The Panel finds that, given Escarcega's emphasis on safety at his seminars and based on JB's testimony that he could not afford to lose the money, Escarcega told JB that the Debentures were safe when in fact they were a high-risk investment. The Panel finds that Escarcega deceived JB and DB into investing in the Debentures by making material oral misrepresentations that they were safe and offered guaranteed interest payments, as alleged in cause one.

Based on JB and DB's age, financial condition, investment objectives, and investment experience, the Panel also finds that Escarcega made an unsuitable recommendation that they invest in the high-risk, speculative Debentures, as alleged in cause three of the Complaint.

b. Escarcega's Written Misrepresentations

Escarcega's written misrepresentations were made to six customers while he filled out their switch letters during his meetings with them about investing in the Debentures. Escarcega does not dispute that he wrote the statements on the switch letters, or that the written misrepresentations were communicated to the customers.[82]

In summary, Escarcega made the following written misrepresentations: He told NZ that the Debentures allowed her to "take advantage of a guaranteed rate return."[83] He told NJ and RJ that the Debentures offered them "guaranteed interest."[84] He told CM the Debentures would "maximize income & liquidity."[85] To MD, Escarcega wrote the Debentures offered "a

[80] Tr. 383-84. Escarcega also argues that the true surrender charge for selling the annuity was approximately $9,000 after subtracting the interest adjustment of $8,677.73 from Midland National's stated surrender cost of $17,028.89. In either case, Escarcega acknowledged that even a surrender charge of $9,000 was too costly to justify the switch. Tr. 386-87, 478-79.

[81] The Panel notes that Escarcega had an opportunity to question JB about whether Escarcega recommended that he hold on to the annuity, but he did not do so. Tr. 184-90.

[82] Tr. 342 (for example, concerning written misrepresentations made to NZ, Escarcega testified, "We filled [the switch letter] out together, so she would have read it."). During questioning by his counsel, Escarcega testified that he never filled out the switch letters after his clients signed them. Accordingly, Escarcega communicated to each of the six customers the misrepresentations that he recorded on their switch letters. Tr. 366-67.

[83] CX-27, at 56.

[84] CX-25, at 23.

[85] CX-26, at 22.

guaranteed rate of return" and "a guaranteed interest payment to be used for monthly income."[86] He told RE the Debentures provided a "guaranteed income stream" and "predictable income and [would] maintain principal."[87]

The following details the customers' overall financial situation and the written misrepresentations Escarcega made to each of the six customers.

i. Customer CM

Customer CM bought a three-year term Debenture in the amount of $117,000 in June 2012 for her IRA. She was a California resident, 66 years old, single, and retired when she invested in the Debentures.[88] CM selected "Growth" as her investment objective on her account application and "Average" to describe both her general investment experience and her experience with alternative investments.[89] According to her suitability verification form, she had an annual income of $65,000 and a net worth of $715,000. The $117,000 investment in the Debentures constituted 16 percent of CM's net worth.[90]

To acquire the funds to buy the Debentures, CM liquidated a $97,000 fixed index annuity she had purchased in 2008, with a then-current death benefit of $120,642 and six years remaining to maturity. According to her switch letter, she incurred a surrender charge of $2,497.[91] Escarcega described the reasons for CM's investment change as: "Client looking to maximize income & liquidity. Existing product did not maximize income needs based on income analysis. Positive market value adjustment." In the space provided on the switch letter to describe the differences between the annuity and the Debentures, Escarcega wrote: "N/A – fixed indexed annuity → debenture offering."[92]

ii. Customer NZ

NZ was a new customer when she first purchased Debentures from Escarcega.[93] She bought a three-year term Debenture in the amount of $30,000 for her trust account, in November 2012, and a four-year term Debenture in the amount of $34,500 for her IRA, in January 2013. NZ was a California resident, retired, single, and 73 years old at the time of the first investment

[86] CX-23, at 30.

[87] CX-24, at 32.

[88] Stip. ¶¶ 37-40; CX-26, at 14.

[89] CX-26, at 14-17.

[90] CX-26, at 18.

[91] CX-26, at 21. Even though he submitted a switch letter for CM's purchase of the Debentures, on CM's suitability verification form, Escarcega checked that her purchase was not a product switch. CX-26, at 19.

[92] CX-26, at 22.

[93] Tr. 338.

and 74 when she made her second investment.[94] On her account applications for both Debenture purchases, NZ selected "Balanced/Conservative Growth" as her investment objective. She said she had over thirty years of experience as an investor, and selected "Average" to describe her level of investment experience. Her experience in alternative investments was "Limited."[95] NZ had an annual income of $62,000 and a net worth of $990,000.[96]

NZ liquidated $10,000 from a managed account, incurring no surrender charges, to purchase the Debenture for her trust, in November 2012.[97] On NZ's switch letter, Escarcega described the reasons for the investment change: "To provide a more predictable rate of return and eliminate management fees. Take advantage of a guaranteed rate of return and then transition to income." Escarcega also described the difference in the two investments: "Current investment was structured to be a current income model utilizing traded ETF/MF investments. New investment is structured as a non-traded offering while also paying a more consistent rate of return."[98] Escarcega testified the reason for the investment switch was that NZ "didn't want to have fluctuation in the market. She wanted to have a consistent, predictable fixed rate of return."[99]

On the switch letter for NZ's second Debenture purchase, in January 2013, Escarcega stated the reasons for the investment change were: "To provide for guaranteed rate of return exclusive of the overall stock markets. Also providing for a shorten [sic] maturity in comparison to the time remaining on her existing annuity." Escarcega said the difference between the annuity and the Debenture was: "Phoenix Life provides for protection of principal while also providing for possible market linked growth. GWG Holdings provides for non-traded corporate bond based investing while providing guaranteed rate of return."[100] For NZ's second Debenture purchase, Escarcega testified that "the reason for the replacement was to give [NZ] more of a fixed rate of return . . . she was looking to have a more consistent rate of return."[101]

iii. Customer MD

Customer MD, an Arizona resident, was 65 years old and retired when he purchased a total of $111,000 in Debentures for his IRA account. In February 2013, he bought a four-year term Debenture for $90,000 and a one-year term Debenture for $21,000.[102] On his account

[94] Stip. ¶¶ 41-44.

[95] CX-27, at 14-17, 48-51.

[96] CX-27, at 26-28, 52-54.

[97] CX-27, at 55.

[98] CX-27, at 56.

[99] Tr. 429.

[100] CX-27, at 28.

[101] Tr. 427.

[102] Stip. ¶¶ 25-28; CX-23, at 35-38.

application for the purchase of the Debentures, MD selected "Balanced/Conservative Growth" as his investment objective and selected "Average" to describe his knowledge and experience with alternative investments.[103] MD had annual income of $72,000 and a net worth of $1,110,000.[104] His investment in the Debentures constituted ten percent of the net worth stated on his account documents.

To come up with a portion of the funds he needed to purchase the Debentures, MD liquidated $42,666 in retirement funds he held in a fixed annuity that he purchased in 2010. According to his switch letter, DM incurred estimated surrender charges of $3,160 for liquidating the annuity.[105]

On MD's switch letter, Escarcega described the reason for changing investments was: "To provide the client with a guaranteed interest payment to be used for monthly income now that he is fully retired. The interest payment [sic] are now consistent/predictable and [not] dependent on possible market appreciation." Escarcega described the different features between the annuity and the Debentures as: "Existing account provides for possible market index performance and guarantee against market losses. GWG provides for guaranteed rate of return not dependent on market performance."[106] Escarcega testified that MD bought the Debentures because he wanted to avoid spending down his annuity principal should the market decline.[107]

iv. Customer RE

Customer RE was a 76-year-old retired Arizona resident at the time of his Debenture purchase.[108] In December 2012, he bought a seven-year term Debenture for his IRA in the amount of $67,000. RE had income of $60,000 and a net worth of $730,000.[109] He selected "Balanced/Conservative Growth" as his investment objective and "Average" to describe his investment experience.[110] In March 2010, when he first opened his IRA account with Escarcega at Center Street, RE selected the most conservative investment objective available on his account application: "Preservation of Principal/Income . . . Very Conservative." To characterize his knowledge and experience with alternative investments, he selected "None." Two years later, when he bought the Debentures, RE's account application said his investment objective was

[103] CX-23, at 35-38.

[104] CX-23, at 26-28.

[105] CX-23, at 29.

[106] CX-23, at 30.

[107] Tr. 435.

[108] Stip. ¶¶ 29-32; CX-24, at 16-19.

[109] CX-24, at 28-30.

[110] CX-24, at 16-19.

"Balanced/Conservative Growth" and that he had "Limited" knowledge and experience with alternative investments.[111]

To purchase the Debenture, RE used retirement funds invested in a fixed annuity that he purchased in 2007 for $54,900. He incurred estimated surrender charges of $2,401 when he liquidated the annuity, which had a then-current death benefit of $71,147.[112]

On RE's switch letter, Escarcega explained the reasons for the Debenture purchase: "To provide for a guaranteed income stream. Given the income needs for the client the current investment was not maintaining client principal balance. Transition allows for client to have a predictable income and maintain principal." Escarcega described the differences between the existing fixed annuity investment and the Debenture: "GWG Holding is an income producing non-traded corporate debt offering. Existing investment is a tax-deferred fixed indexed annuity providing for guarantee of principal and potential growth."[113]

Regarding RE's investment in the Debentures, Escarcega testified that when he said the Debentures would "maintain principal" he meant that, because they do not trade, the Debentures would not have the "feature of . . . principal volatility," and with "the Debentures, similar [to] other nontraded investments [] it doesn't matter whether the stock market goes up down or sideways."[114]

v. Customers NJ and RJ

NJ and his wife RJ purchased a three-year term Debenture for their trust account in the amount of $52,875, in December 2012. They were California residents, retired, and 75 and 70 years old, respectively, at the time of their purchase.[115] They selected "Balanced/Conservative Growth" as their investment objective and "Average" to characterize their investment experience.[116] They had annual income of $85,000 and a net worth of $1,685,000.[117]

To buy the Debenture, RJ and NJ sold a $50,000 indexed zero coupon CD they purchased in 2010, with six years remaining to maturity. They incurred no surrender charges.[118] Escarcega's explanation for the investment switch was: "Clients requested to have guaranteed interest associated with GWG Holdings Debentures. The ability to have returns not dependent on the stock market & shortened maturity." He described the differences between the two

[111] CX-24, at 17, 43.

[112] CX-24, at 31.

[113] CX-24, at 32.

[114] Tr. 433-34.

[115] Stip. ¶¶ 33-36.

[116] CX-25, at 13-16.

[117] CX-25, at 19-21.

[118] CX-25, at 22-23.

investments as: "Current CD has a 6 year maturity with zero coupon payments (SP500 linked CD). GWG debenture has a 3 year maturity with an 8% annual interest payment."[119] Escarcega testified that RJ and NJ "wanted a more – a fixed rate of return" and were "looking for something more finite."[120]

2. Escarcega Acted with Scienter

The Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[121] Scienter may also be established by a showing of recklessness.[122] Recklessness has been defined as "an extreme departure from the standards of ordinary care."[123] A reckless action "is one made that departs so far from the standards of ordinary care that it is very difficult to believe the [actor] was not aware of what he was doing."[124]

Escarcega knew that his customers sought safety in their investments, and accordingly pitched his securities seminars around the notion of "finding safety in an unstable economy." He understood that his customers, most of whom were retired and elderly, wanted guarantees and safety in their investments. The Panel finds that Escarcega repeatedly described the Debentures as "guaranteed" or offering guaranteed returns to induce his customers to invest in them.

Escarcega argues that his use of "guarantee" was a "lapse in judgment" and an "error."[125] Escarcega testified that after he used the word "guarantee" for the first time on a switch form, and his firm did not question its use, "it was used in conjunction again."[126] Escarcega also stated that by "guarantee" he "intended to pass along to the clients that this is a fixed stated rate of return" and that it was "taken out of context."[127] Although his statements to customers varied, in each case, Escarcega stressed to them the safety and security of the Debentures.

Escarcega was an experienced broker. He was familiar enough with the Debentures to know that the investment was in fact risky and not guaranteed.[128] Escarcega testified that he read the Prospectus, which repeatedly stressed that the Debentures are speculative, illiquid, and high-risk investments, and that investors could lose their entire investment principal.

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[119] CX-25, at 23.

[120] Tr. 431-32.

[121] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[122] *DWS Securities Corp*., 51 S.E.C. 814, 821 (1993).

[123] *Hollinger v. Titan Capital Corp*., 914 F.2d 1564, 1569 (9th Cir. 1990).

[124] *First Commodity Corp. v. CFTC*, 676 F.2d 1, 7 (1st Cir. 1982).

[125] Tr. 342, 364.

[126] Tr. 364.

[127] Tr. 435.

[128] Tr. 444-45 (Escarcega acknowledging that the Debentures were not "guaranteed").

The Panel finds that Escarcega's intentional or reckless disregard of Arizona's ten percent restriction on sales of alternative investments and the high concentration in the Debentures for all his customers is compelling circumstantial evidence of his intent to misrepresent the safety of the Debentures. Escarcega knew about Arizona's ten percent investment limit, but he ignored this restriction. He knowingly or recklessly exceeded the limit with eight Arizona customers. The Panel finds that Escarcega ignored the net worth limitations to maximize his sales of Debentures.

The Panel finds that Escarcega intentionally or recklessly misrepresented and omitted material facts about the Debentures to seven customers. The Panel finds that he willfully violated Section 10(b) of the Exchange Act, Rule 10b-5 thereunder,[129] and FINRA Rules 2020 and 2010.

B. Escarcega Made Unsuitable Recommendations to Twelve Customers

Enforcement alleges in the third cause of action that Escarcega made unsuitable recommendations to 12 customers by failing to consider the age, financial situation, investment objectives and experience, risk tolerance, need for liquidity, net worth, and income of each individual customer. Because only one customer testified at the hearing, Enforcement relied primarily on the information contained in the customers' account documents to show that the Debentures were unsuitable investments.

1. The Suitability Rules

Escarcega's recommendations to customers to invest in the GWG Debentures occurred between March 2012 and January 2013. NASD Rule 2310[130] was in effect until July 9, 2012, when it was replaced by FINRA Rule 2111.[131] Both Rules require that a broker's

[129] Escarcega's willful violation of Section 10(b) of the Exchange Act and Rule 10b-5 results in his statutory disqualification. *Dep't of Enforcement v. Ahmed*, No. 2012034211301, 2015 FINRA Discip. LEXIS 45, 90 n.84 (NAC Sept. 25, 2015) (stating that respondents are statutorily disqualified as a result of violating Section 10(b) of the Exchange Act and Rule 10b-5), citing *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) ("'[W]illfully' in [the Exchange Act] means intentionally committing the act which constitutes the violation," not that "the actor [must] also be aware that he is violating one of the Rules or Acts."); *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 SEC LEXIS 558, at *3 n.2 (Feb. 13, 2015) (stating that applicants were statutorily disqualified because they willfully violated Section 10(b) of the Exchange Act and Rule 10b-5); *see also* Sections 3(a)(39)(F) (15 U.S.C. § 78c(a)(39)(F)) and 15(b)(4)(D) (15 U.S.C. § 78o(b)(4)(D)) of the Exchange Act; Article III, Section 4 of FINRA's By-Laws.

[130] NASD Rule 2310(a) stated, "In 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."

[131] FINRA Rule 2111(a) states, "A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

recommendation be suitable to the customer based on the customer's financial needs and circumstances. NASD Rule IM 2310-02(a)(1) and its replacement, FINRA Supplementary Material 2111.01, state that fair dealing is a fundamental responsibility of brokers and is implicit in their relationships with customers.[132] Supplemental Material 2111.01, which became effective July 9, 2012, adds specifically that the "suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."

The suitability rule requires a registered representative to have a reasonable belief that recommended transactions are suitable for a customer, based on information obtained from the customer and a reasonable inquiry into the customer's investment objectives, financial situation, and needs.[133] A broker's recommendations must also be consistent with the customer's best interests[134] and adhere to the fundamental responsibility of fair dealing with customers.[135] A broker must "tailor his recommendations to the customer's financial profile and investment objectives."[136] A recommendation violates the suitability rule if a broker inadequately assesses whether the recommendation is suitable for a specific customer.[137] Even when a customer "affirmatively seeks to engage in highly speculative or aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile."[138] In addition, a recommendation that results in concentration in an investment that is more aggressive than a customer's circumstances dictate is unsuitable.[139]

Escarcega relies on the fact that the risks of investing in the Debentures were amply disclosed to customers in the Prospectus and in other documents. But merely disclosing risks to a customer is insufficient to meet a broker's suitability obligation when making a

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[132] *See Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *39 (Jan. 30, 2009) (citing former NASD Rule IM-2310-2(a)(1), which stated: "Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public.").

[133] *Rafael Pinchas*, 54 S.E.C. 331, 340-41 (1999).

[134] *Epstein*, 2009 SEC LEXIS 217, at *40 n.24 (citing *Raghavan Sathianathan*, Exchange Act Release No. 54722, 2006 SEC LEXIS 572, at *21 (Nov. 8, 2006)); *Dep't of Enforcement v. Dunbar*, No. C07050050, 2008 FINRA Discip. LEXIS 18, at *20 (NAC May 20, 2008).

[135] *Epstein*, 2009 SEC LEXIS 217, at *38-39.

[136] *Id*. at *43 (quoting *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168 (1989)).

[137] *Michael Frederick Siegel*, Exchange Act Release No. 58737, 2008 SEC LEXIS 2459, at *28-29 (Oct. 6, 2008) ("The suitability rule thus requires that, before making a customer-specific suitability determination, a registered representative must first have an 'adequate and reasonable basis' for believing that the recommendation could be suitable for at least some customers.") (citing *Terry Wayne White*, 50 S.E.C. 211, 212 n.4 (1990), *aff'd as to liability and sanctions, remanded as to restitution*, 592 F.3d 147 (D.C. Cir. 2010)).

[138] *Dep't of Enforcement v. O'Hare*, No. C9B030045, 2005 NASD Discip. LEXIS 39, at *12 (NAC Apr. 21, 2005). *See also Pinchas*, 54 S.E.C. at 342 (finding customer's desire to "double her money" does not relieve registered representative of duty to recommend only suitable investments).

[139] *See Clinton Hugh Holland, Jr.*, 52 S.E.C. 562, 566 (1995), *aff'd sub nom. Holland v. SEC*, 105 F.3d 665 (9th Cir. 1997) (table format); *see also Jack H. Stein*, 56 S.E.C. 108 (2003); and *James B. Chase*, 56 S.E.C. 149 (2003).

recommendation; a broker must also ensure that the customer understands the risks of an investment and affirmatively determine that the investment is suitable for the customer.[140] Escarcega also argues that his recommendations of the Debentures were suitable in light of his customers' stated investment objectives. However, a broker cannot rely on a customer's investment objectives to justify an unsuitable recommendation if the investment is unsuitable for the customer given the customer's financial profile.[141]

2. The Customers

The Complaint alleges that Escarcega's recommendations to invest in GWG Debentures were unsuitable for 12 customers. The Extended Hearing Panel, relying on information contained in the customers' account documents and testimony presented at the hearing, concludes that Escarcega's recommendations to the 12 customers were clearly unsuitable. The Debentures were unsuitable because of the age of the customers, their individual financial situations, investment objectives, low risk tolerance, and the excessive concentration the Debentures represented in relation to the customers' net worth.

In addition to the fact that the Debentures were described by GWG as high-risk investments and suitable only for those persons who could afford to lose all of their investment, the following general characteristics of the 12 customers underscore how unsuitable Escarcega's recommendations were.

- Eleven of the 12 investors were retired at the time of their purchase of the Debentures.[142]

- Nine of the 12 investors were over 70 years old; the youngest (PM) was 61 and she was retired. The oldest investors (RS and SM) were 81 years old at the time of their investments.[143]

- Ten of the 12 investors selected "Balanced/Conservative Growth" as their investment objective on their account applications; the other two (SC and RL) selected the most conservative investment objective available on the account application—"Preservation of Principal/Income."

- According to their account applications, ten of the 12 investors had an "Average" understanding of investments generally.[144]

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[140] *Dep't of Enforcement v. Chase*, No. C8A990081, 2001 NASD Discip. LEXIS 30, at *17 (NAC Aug. 15, 2001) (citing *Patrick G. Keel*, 51 S.E.C. 282, 286 (1993)).

[141] *John M. Reynolds*, 50 S.E.C. 805, 809 (1991) (stating that a broker is charged with making recommendations in the best interests of his customer even when such recommendations contradict the customer's wishes to engage in aggressive and speculative trading).

[142] Stip. ¶¶ 20, 24, 48, 52, 60, 65, 69. Only NH, age 65, was not retired at the time of her Debenture purchase. CX-30, at 16.

[143] Stip. ¶¶ 20, 24, 48, 52, 60, 65, 69; CX-33, at 42, 46.

- According to their account applications, nine of the 12 investors had an "Average" understanding of alternative investment products, like the GWG Debentures. Three customers (RS and PM, a married couple, and RL) said they had a "Limited" understanding of alternative investments. (Escarcega testified that he selected "Average" for his customers' understanding of alternative investments because he had explained the Debentures' features to them, not because they had an existing understanding of alternative investments.)[145]

- All of the investors used a more secure investment to acquire some or all of the funds to buy their Debentures.

- Customer concentration in the Debentures as a percentage of their net worth ranged from 10 percent to 33 percent.[146]

Escarcega testified that he understood the Debentures carried risk. For example, he knew that the investment was speculative and that investors could lose their investment.[147] He also knew that the Debentures were suitable only for persons with sufficient financial resources and with no need for liquidity.[148] Notwithstanding his understanding of the risks involved, Escarcega recommended the Debentures to his customers.

In addition to the customers discussed below, the Extended Hearing Panel finds that Escarcega made unsuitable recommendations to customers JB and DB that they invest in the Debentures, as Enforcement alleges.

a. Customer PB

PB is an Arizona resident and was 76 years old, retired, and single when she invested a total of $267,000 in the Debentures. She purchased a seven-year Debenture in the amount of $148,000, in August 2012, and another seven-year term Debenture in the amount of $119,000 for her IRA, in January 2013.[149] On the account applications for each investment, PB said her investment objective was "Balanced/Conservative Growth" and her investment experience was "Average." PB had "Average" experience with alternative investments.[150]

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[144] Two customers (JS and MS, a married couple) described their general investment experience as "Extensive" but selected only "Average" to describe their experience with investing in stocks, bonds, mutual funds, and annuities. CX-34, at 14, 40.

[145] Tr. 449-51.

[146] CX-50.

[147] Tr. 307 (Escarcega testifying that the Debentures are "a debt security, so [investors] have the ability to lose their money, yes.").

[148] Tr. 307-08.

[149] Stip. ¶¶ 45-48.

[150] CX-28, at 27-30, 58-61.

PB's annual income was $60,000. At the time of her first purchase of Debentures, in August 2012, PB's suitability verification form said she had a net worth of $860,000.[151] Accordingly, PB's first investment in the Debentures for $148,000 constituted over 17 percent of her declared $860,000 net worth. When she made her second investment, in January 2013, PB said her net worth was $1,025,000.[152] PB's combined investment of $267,000 constituted at least 26 percent of her net worth, assuming it was $1,025,000. Assuming her net worth was $850,000, as reported in August 2012, the two Debenture purchases amounted to more than 31 percent of PB's net worth.

b. Customer NH

NH was an Arizona resident, 65 years old, married, and employed as an executive assistant at the time of her purchase of the Debentures. In March 2012, she invested $329,500 in a seven-year term Debenture for her IRA account.[153] NH was referred to Escarcega by his business partner at Strategic Financial.[154]

NH's investment objective for her IRA account was "Balanced/Conservative Growth" and her investment experience was "Average."[155] Her account application stated she had "Average" experience with alternative investments.

NH had a net worth of $1.2 million and annual income of $98,000.[156] NH's investment in the Debentures for her IRA account constituted over 27 percent of her net worth. Escarcega described NH's concentration in the Debentures as "high," an "error," and "an overage" that would "raise a concern" for him.[157] Center Street's CEO described NH's concentration in the Debentures as "extremely high."[158]

c. Customer SC

SC was 73 years old, retired, single and resided in Arizona when she invested $78,000 in a seven-year term Debenture for her IRA account in March 2012. She was a new customer who had been referred to Escarcega by another broker. SC had a net worth of $550,000 and an annual

[151] CX-28, at 62-64.

[152] CX-28, at 24-26.

[153] Stip. ¶¶ 55-56; CX-30, at 16.

[154] Tr. 359.

[155] CX-30, at 16-19.

[156] CX-30, at 20-22.

[157] Tr. 360.

[158] Tr. 75.

income of $48,000.[159] SC's investment in the Debentures constituted over 14 percent of her net worth. Escarcega described the Debenture concentration level as an "overage."[160]

On her account application, SC described her investment objective as "Preservation of Principal/Income . . . Very Conservative"—the most conservative description available— and her general investment experience as "Average." She had an "Average" understanding of alternative investments.[161] Escarcega explained that SC selected "Very Conservative" as her overall investment objective because she "was utilizing the debenture to take income."[162]

d. Customer RL

RL, an Arizona resident, was 65 years old and retired when he purchased a $99,000 three-year term Debenture in April 2012 for his IRA account.[163] RL's suitability verification form states that his net worth was $625,000 and his annual income was $55,000 at the time of the Debenture purchase.[164] His investment in the Debentures amounted to 16 percent of his total net worth.

RL described his investment objective as "Preservation of Principal/Income . . . Very Conservative" and his overall investment experience as "Average." He had "Limited" experience with alternative investment products.[165] Escarcega testified that, like customer SC, RL selected the most conservative investment objective for his account because "this investment [in the Debenture] was initially set up to start taking income from day one."[166]

e. Customers JS and MS

JS and MS, a married couple, were residents of Washington, retired, 77 and 75 years old, respectively, when they purchased a total of $383,014 in Debentures.[167] In August 2012, they purchased a seven-year term Debenture in the amount of $231,014 for a joint account. In September 2012, MS invested in a seven-year term Debenture in the amount of $152,000 for her IRA account.[168]

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[159] Stip. ¶¶ 48-52; CX-29, at 2-3, 25-27; Tr. 349.

[160] Tr. 350.

[161] CX-29, at 21-24.

[162] Tr. 349-50.

[163] Stip. ¶¶ 21-24.

[164] CX-22, at 20.

[165] CX-22, at 15-18.

[166] Tr. 346.

[167] Stip. ¶¶ 66-69.

[168] CX-34, at 6-10, 31-34.

JS and MS had a net worth of $1,165,000 and annual income of $65,000. Their combined investment of $383,014 in the Debentures constituted 33 percent of their net worth. Their stated investment objective on both account applications was "Balanced/Conservative Growth." The account applications stated they had "Extensive" general investment experience, but with respect specifically to stocks and bonds, mutual funds, and annuities, they stated they had only "Average" experience. JS and MS had "Average" experience with alternative investment products.[169] On the suitability verification forms for both purchases, the couple's stated investment objective was "Growth."[170]

f. Customers WJ and SM

WJ and SM, a married couple and California residents, were retired and 73 and 81 years old, respectively, when they bought $156,300 in Debentures. In July 2012, they purchased a one-year term Debenture for $22,300 and a five-year term Debenture for $134,000 for their joint account.[171] Their stated net worth was $1,040,000 and annual income $70,000 at the time of the investments. The $156,300 investment in the Debentures represented 15 percent of their net worth.[172]

WJ and SM checked "Balanced/Conservative Growth" as their investment objective and "Average" to describe their investment experience on their new account application. They said they had "Average" experience with alternative investment products.[173]

g. Customers RS and PM

RS and PM, a married couple and Arizona residents, were retired and 81 and 61 years old, respectively, when they invested a total of $65,000 in the Debentures. RS and PM purchased a one-year term Debenture in the amount of $25,000 for a joint account, in March 2012. RS purchased a seven-year term Debenture in the amount of $40,000 for his IRA account, in April 2012.[174]

RS and PM had a net worth of $650,000 and annual income of $70,000. Their $65,000 investment in the Debentures represented ten percent of their net worth.[175] The applications for both accounts stated their investment objective was "Balanced/Conservative Growth" and their

[169] CX-34, at 14, 40.

[170] CX-34, at 17, 44.

[171] Stip. ¶¶ 57-60.

[172] CX-31, at 16-18.

[173] CX-31, at 12-15.

[174] Stip. ¶¶ 61-65.

[175] CX-33, at 18-20, 46-48.

investment experience as "Average." RS and PM's experience with alternative investment products was "Limited."[176]

Based on the forgoing, the Panel finds that Escarcega made unsuitable recommendations to the 12 customers that they invest in the Debentures, in violation of NASD Rule 2310 and FINRA Rules 2111 and 2010, as alleged in cause three of the Complaint.[177]

C. Escarcega Generated False Books and Records

The fifth cause of action alleges that Escarcega created inaccurate firm books and records when he falsely indicated on documentation for two accounts—JB and DB (husband and wife) and CM—that the customers did not liquidate, redeem, or exchange an existing investment to acquire funds needed to purchase GWG Debentures. Enforcement also alleges that Escarcega intentionally overstated JB and DB's net worth by $300,000 on application forms for the Debentures.

FINRA Rule 4511(a) requires FINRA members to "make and preserve books and records as required under the FINRA rules, the Exchange Act, and the applicable Exchange Act rules." SEC Rule 17a-3(a)(17) requires firms to maintain books and records for their customers. Causing a firm to maintain false books and records violates FINRA Rules 4511 and 2010.[178] Compliance with recordkeeping rules is essential to the proper functioning of the regulatory process. "Indeed, the Commission has stressed the importance of the records that broker-dealers are required to maintain pursuant to the Exchange Act, describing them as the 'keystone of the surveillance of brokers and dealers by our staff and by the securities industry's self-regulatory bodies.'"[179] Scienter is not required to prove a books and records violation of Rule 4511(a).[180]

1. Customers JB and DB

In March 2012, customer JB liquidated a fixed annuity contract, incurring a surrender charge of $17,028.89.[181] Within a few days, JB and DB used the proceeds from the liquidation to invest $117,000 in the Debentures that Escarcega had recommended to them. On the customers' account documents, however, Escarcega did not disclose to Center Street that the Debenture

[176] CX-33, at 42-45, 46-48.

[177] A violation of the suitability rule also violates FINRA Rule 2010. *Wendell D. Belden*, 56 S.E.C. 496, 505 (2003).

[178] FINRA Rule 140 provides that FINRA Rules apply to member firms and associated persons. Accordingly, as an associated person, Escarcega has an obligation to comply with Rule 4511. An associated person who violates Rule 4511 also violates Rule 2010's requirement that members observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. *See, e.g.*, *Fox & Co. Inv., Inc.*, 58 S.E.C. 873, 891-93 (2005).

[179] *Dep't of Enforcement v. Trevisan*, No. E9B2003026301, 2008 FINRA Discip. LEXIS 12, at *35 (NAC Apr. 30, 2008) (quoting *Edward J. Mawood & Co.*, 46 S.E.C. 865, 873 n.39 (1977), *aff'd*, 591 F.2d 588 (10th Cir. 1979)).

[180] *Joseph G. Chiulli*, 54 S.E.C. 515, 522 (2000) (holding that NASD Rule 3110, the predecessor to FINRA Rule 4511, has no scienter requirement).

[181] CX-20, at 2.

purchase was a product switch.[182] Also, he did not submit a switch letter to the firm on behalf of JB and DB.

As discussed above, the Extended Hearing Panel finds that Escarcega also intentionally overstated JB and DB's net worth by approximately $400,000 on firm documents. Their account documents stated that their net worth was $635,000 when their actual net worth was closer to $210,000.[183] Overstating JB and DB's net worth helped Escarcega justify to his firm their $117,000 investment in the Debentures.

The Extended Hearing Panel finds that Escarcega violated FINRA Rules 4511 and 2010 by failing to disclose to Center Street that JB and DB were liquidating one investment—an annuity—to purchase the Debentures and by significantly overstating their net worth on their account forms. Escarcega's failure caused the firm to maintain incorrect books and records.

2. Customer CM

The Extended Hearing Panel finds that Escarcega did not violate Rule 4511 relating to customer CM's product switch. Enforcement alleges that Escarcega violated Rule 4511 because he did not check the box on CM's suitability verification form indicating that she intended to sell an existing investment to acquire the funds to purchase the Debentures. However, Escarcega submitted to Center Street a switch letter dated June 7, 2012, and signed by CM and Escarcega. The switch letter disclosed to the firm that CM would incur a surrender charge of $2,497 for liquidating a fixed index annuity that she had purchased in 2008 for $97,000.[184] CM used the proceeds from the fixed annuity to purchase a three-year Debenture in the amount of $117,000 on June 21, 2012.[185]

Escarcega disclosed CM's investment switch by submitting her switch letter to Center Street. The switch letter was signed by Escarcega and CM on the same date—June 7, 2012—that they signed the suitability verification form on which Escarcega failed to indicate that the transaction resulted from a product switch, suggesting that the two forms were submitted to the firm together.[186]

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[182] CX-19, at 14-16. Escarcega checked "No" in response to the question, "Were other investments liquidated, redeemed or exchanged within the last 30 days . . . to provide funds for this transaction?" Had he checked "Yes" to the question, Escarcega would have been obligated to complete a switch letter in connection with JB and DB's purchase of the Debentures.

[183] CX-19, at 14-16.

[184] CX-26, at 21. Escarcega also made another disclosure on the switch letter stating that the "existing product did not maximize income needs." CX-26, at 22.

[185] Stip. ¶ 39.

[186] Tr. 227 (Enforcement's investigator testifying that customer account documents were received from Center Street pursuant to Rule 8210 requests).

Because he submitted a switch letter, the Panel finds that Escarcega's failure to affirmatively indicate on CM's suitability verification form that she was switching from one investment to the Debenture fails to constitute a violation of Rule 4511.

D. Enforcement Failed to Prove that Escarcega Distributed a Misleading GWG Sales Brochure

The fourth cause of action alleges that Escarcega distributed to customers a misleading sales brochure, or fact sheet, advertising the GWG Debentures, in violation of NASD Rule 2210(d)(1)(A) and FINRA Rule 2010. The Complaint alleges that the brochure was misleading because it incorrectly stated that the Debentures were secured by life insurance policies GWG had purchased, and it failed to disclose that investors' interests in the Debentures were subordinate to other creditors of GWG's subsidiaries.[187]

NASD Rule 2210 generally governs FINRA member communications with the public and includes certain content standards that apply to all member communications, as well as specific standards that apply to sales literature.[188] The GWG fact sheet falls within the Rule's definition of "sales literature."[189] NASD Rule 2210(d)(1)(A) states that "communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service." The communications must not "omit any material fact or qualification if the omission" would cause the communications to be misleading.[190]

GWG provided written sales materials to Center Street and Escarcega to use in offering its Debentures to customers. One was a sales brochure that was reviewed by FINRA's advertising department before it was distributed to prospective investors.[191] Escarcega circulated the GWG sales brochure to at least 20 customers beginning in March 2012.[192] The four-page sales brochure stated that, "Renewable Secured Debentures are secured by the corporate assets of GWG, which consist primarily of investments in life insurance policies purchased in the secondary market."[193]

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[187] Compl. ¶ 60.

[188] *See* NASD Rule 2210(d). The rules that apply in this case are those that existed at the time of the conduct at issue. On March 29, 2012, the SEC approved new FINRA rules governing communications with the public that became effective February 4, 2013. *See* FINRA Regulatory Notice 12-29, 2012 FINRA LEXIS 36 (June 2012).

[189] *See* NASD Rule 2210(a)(2).

[190] NASD Rule 2210(d)(l)(A). The Rule's general content standards also prohibit FINRA members and associated persons from making false, exaggerated, unwarranted, or misleading statements or claims in any communications with the public. NASD Rule 2210(d)(1)(B).

[191] Stip. ¶ 70.

[192] Stip. ¶ 71.

[193] CX-44, at 2.

This statement is misleading, Enforcement alleges, because, as set forth in the Prospectus, the life insurance policies are in fact held by a subsidiary of GWG—not GWG itself—and are pledged as collateral to the senior creditor providing a $100 million revolving line of credit.[194] Enforcement argues that the GWG sales brochure is misleading because it did not adequately disclose that the life insurance policies were not collateral for the Debentures or held by a subsidiary of a subsidiary of GWG. Nor did the brochure tell possible investors that the policies had already been pledged to a creditor offering an important line of credit to GWG.[195] In November 2012, at FINRA's request, GWG revised the sales brochure to correct the sentence that Enforcement contends is misleading.[196]

Escarcega's defense to the advertising allegation is that it was reasonable for him to rely on the fact that GWG and Center Street had approved the sales brochure for distribution to customers and that it had been reviewed by FINRA.[197] Additionally, he points out that FINRA reviewed four different forms of advertising prepared by GWG about the Debenture offering—a flyer, a postcard, a newspaper ad, and a magazine ad—which he used to market the investment to customers.[198] After receiving Center Street's approval, Escarcega circulated the advertisements containing his contact information to potential investors.[199]

The Panel finds that the sales brochure is not misleading. The sales brochure contained a section entitled "Risks Involving Renewable Secured Debentures." GWG's summary of the risks of investing in the Debentures included their "subordination to senior debt."[200] The sales brochure warned investors that they should purchase the Debentures only if they are able to bear the risk of losing the entire investment.[201] It also did not specifically claim that the life insurance policies were collateral for the Debentures. Rather, the brochure stated that the Debentures were secured by "all the corporate assets of GWG." The subsidiary that held the life insurance policies was wholly owned by GWG.

Finally, the sales brochure warned investors that they must read "the entire Prospectus for investment conditions, risk factors, . . . and other pertinent information with respect to the Renewable Secured Debentures in order to obtain the information essential to making an

[194] CX-13, at 1, 27-28; CX-14, at 1, 29-30; CX-44, at 3.

[195] Enforcement's Post-Hearing Brief, at 23.

[196] Tr. 54, 244. The sales brochure that was revised in November 2012 was not offered in evidence so the Extended Hearing Panel is not able to compare the language in the two versions of the brochure.

[197] Ans. ¶¶ 60-61; Escarcega's Post-Hearing Brief, at 34; Stip. ¶¶ 70-71.

[198] Tr. 389-93; RX-8, at 3-4; RX-9, at 4-5; RX-10, at 3-4; RX-11, at 3-4.

[199] RX-12; RX-13; RX-14; RX-15; Tr. 394-96.

[200] CX-44, at 4.

[201] CX-44, at 4.

informed investment decision."[202] Escarcega testified that the Prospectus, including supplements, was distributed to customers in a package with the sales brochure.[203]

In light of the foregoing, the Panel dismisses the fourth cause of action alleging that Escarcega violated NASD Rule 2210(d)(1)(A) and FINRA Rule 2010.[204]

V. SANCTIONS

The Panel applied FINRA's Sanction Guidelines ("Guidelines") in considering the appropriate sanction to impose on Escarcega.[205] The Guidelines contain eight "General Principles" and 19 "Principal Considerations" that apply to all violations, and additional guidelines tailored to specific violations. Two of the General Principles are applicable here. General Principle No. 1 states that "sanctions should be designed to protect the investing public by deterring misconduct and upholding high standards of business conduct." Adjudicators accordingly should "design sanctions that are meaningful and significant enough to prevent and discourage future misconduct by a respondent and deter others from engaging in similar misconduct." Sanctions should "reflect the seriousness of the misconduct at issue."[206] General Principle No. 2 instructs adjudicators to "tailor sanctions to respond to the misconduct at issue," so that the sanctions imposed "address the misconduct involved in each particular case."[207]

A. Causes One and Three: Fraud and Unsuitable Recommendations

The Guidelines for fraud, misrepresentations, or material omissions of fact involving intentional or reckless misconduct recommend that adjudicators "strongly consider" barring an individual. Where mitigating factors predominate, the Guidelines recommend that adjudicators consider suspending an individual for a period of six months to two years.[208]

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[202] CX-44, at 4.

[203] Tr. 380-81.

[204] The Panel's dismissal of the advertising charge is consistent with the hearing panel's decision in *Dep't of Enforcement v. Wall Street Strategies, Inc*., No. 2012033508702, 2015 FINRA Discip. LEXIS 64, at *86-87 (OHO Sept. 15, 2015), *appeal docketed* (NAC Oct. 9, 2015). In that case, which involved the same GWG sales brochure and virtually identical charges, the panel dismissed allegations that the respondent firm and its President and Chief Compliance Officer violated NASD Rule 2210(d)(1)(A). The panel found that "the differences between the original, allegedly misleading language and the revised, not misleading language [in the sales brochure] are not sufficiently significant to support a finding that the original version violated Rule 2210. . . . Respondents distributed the [sales brochure] in reliance on FINRA's advertising department's Clean Letter's statement that it appeared to be 'consistent with applicable standards,' before FINRA's advertising department revisited the matter."

[205] FINRA Sanction Guidelines (2015), http://finra.org/industry/sanction-guidelines.

[206] Guidelines at 2 (General Principles Applicable to All Sanction Determinations, No. 1).

[207] Guidelines at 3 (General Principles Applicable to All Sanction Determinations, No. 3).

[208] Guidelines at 88. The Guidelines also instruct adjudicators to consider a fine ranging from $10,000 to $146,000 for intentional or reckless misconduct.

The Guidelines for making unsuitable recommendations to customers recommend a fine between $2,500 and $110,000 and a suspension in any or all capacities of ten business days to two years. Where aggravating factors predominate, the Guidelines ask that adjudicators "strongly consider" barring an individual respondent. The Guidelines further state that adjudicators should also order disgorgement, as set forth in General Principle No. 6.[209]

The Guidelines contain no principal considerations specifically tailored to material misrepresentations and unsuitable recommendations. The Panel therefore applied the Principal Considerations for all violations.[210] Escarcega's fraudulent misrepresentations and unsuitable recommendations are related. The Panel imposes a unitary sanction for these two egregious violations.[211] The sanctions the Panel imposes are therefore designed to deter the same underlying misconduct. For the following reasons, the Panel determines that Escarcega should be barred and ordered to disgorge $52,270 as a fine, which equals the commissions that GWG paid him for his sales to the 18 customers.

In applying the Principal Considerations, the Panel concludes that there are multiple aggravating factors that weigh in favor of a bar. Particularly relevant in this case is that Escarcega engaged in numerous transactions over a ten-month period.[212] Escarcega's misrepresentations and unsuitable recommendations resulted in 18 customers investing more than $1.8 million in the Debentures.[213] The seven customers to whom Escarcega made material misrepresentations invested a total of $516,875 in the Debentures.

None of the 18 customers was younger than 61 and all but one was retired. Eleven customers were in their 70's and the two oldest investors were 81 years old. Escarcega placed as much as 33 percent of one customer's net worth in the Debentures. Escarcega's misconduct resulted in his earning $52,270 in commissions.[214] The Panel finds that Escarcega also acted intentionally, or at a minimum recklessly, when he made his misrepresentations and unsuitable recommendations.[215] He effectively ignored the detailed and explicit warnings of the risks of investing in the Debentures contained in the Prospectus.

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[209] Guidelines at 94 n.1.

[210] Guidelines at 6-7.

[211] *Dep't of Enforcement v. Mielke*, No. 2009019837302, 2014 FINRA Discip. LEXIS 24, at *55 (NAC July 18, 2014) (citing *Dep't of Enforcement v. Fox & Co. Inv., Inc*., No. C3A030017, 2005 NASD Discip. LEXIS 5, at *37 (NAC Feb. 24, 2005) (finding that "where multiple, related violations arise as a result of a single underlying problem, a single set of sanctions may be more appropriate to achieve NASD's remedial goals")), *aff'd*, 58 S.E.C. 873, 894 (2005).

[212] Guidelines at 6 (Principal Consideration in Determining Sanctions, Nos. 8, 9).

[213] Guidelines at 7 (Principal Consideration in Determining Sanctions, No. 18).

[214] Guidelines at 7 (Principal Consideration in Determining Sanctions, No. 17). Including the six Arizona customers whose investment amounts were later reduced because they placed more than ten percent of their net worth in the Debentures, Escarcega earned a total of $69,988 in commissions. Escarcega had to return $17,718 in commissions he had been paid. CX-42.

[215] Guidelines at 7 (Principal Consideration in Determining Sanctions, No. 13).

When opening their accounts, all of the customers selected conservative investment objectives that were inconsistent with the risks presented by the Debentures. With one exception, the 18 customers had "Average" general investment experience. Five customers stated they had a "Limited" understanding of alternative investments, while the rest had an "Average" understanding of such products.[216] He also ignored his customers' financial situations and needs. To justify his recommendations, he downplayed the risks presented by the Debentures. He testified that all investment products carry some risk, thereby suggesting that he made little or no distinction between the risky investment represented by the Debentures and traditional conservative investment products.[217] Escarcega did not accept responsibility for his misconduct and expressed no remorse for his actions.[218] Escarcega's failure to appreciate his obligations as a registered representative and the gravity of his misconduct warrants a bar.

It is not mitigating, as Escarcega argues,[219] that to date customers have not suffered losses from their investments in the Debentures.[220] Escarcega could not have known that his customers would not lose money at the time he made his fraudulent statements and unsuitable recommendations, and the risk of loss to the customers remains. The Panel has considered that all but four of the 18 customers remain invested in the Debentures.[221] Nine customers purchased seven-year term Debentures that will mature no sooner than 2019. Their investments in seven-year Debentures totaled $1,269,014.[222] Five of the nine customers were Arizona residents whose investment amounts were reduced by GWG to meet the state's ten percent net worth

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[216] Guidelines at 7 (Principal Consideration in Determining Sanctions, No. 19).

[217] Tr. 307 (Escarcega stating that language about risk and speculation in the Prospectus is similar to statements "we see in a lot of different products"). When asked whether he thought the Debentures were speculative investments, Escarcega said, "It's language used in the prospectus. There's not any one security that I offer that doesn't have a degree of risk. . . . I don't know if I could readily agree with you [that the debentures are speculative] one way or the other. It's language used in the prospectus stating – relating to the GWG debentures." Tr. 321-22.

[218] Escarcega displayed indifference to his responsibilities under FINRA rules. He testified that, as a result of the disciplinary action, he has learned to "[n]ot us[e] a quote/unquote, 'naughty word.' That seems to be the reason why I'm sitting here." Tr. 494.

[219] Escarcega's Post-Hearing Reply Brief, at 12-13. Escarcega argues that, "There was no harm to the investing public" and the customers "all made money from their investments." *Id*. at 13.

[220] *Donner Corp. Int'l*, Exchange Act Release No. 55313, 2007 SEC LEXIS 334, at *73 n.91 (Feb. 20, 2007) (affirming NASD bars for two brokers who violated Section 10(b) of the Exchange Act and Rule 10b-5 by disseminating research reports that omitted negative financial information and contained exaggerated claims about issuer notwithstanding absence of evidence of customer harm); *Coastline Fin., Inc*., 54 S.E.C. 388, 395-96 (1999) (in affirming NASD's expulsion of firm and bar of its owner in fraudulent sales practices case finding violations of Section 10(b) of the Exchange Act and Rule 10b-5, rejecting absence of customer harm as a mitigating factor for sanctions); *Cody v. SEC*, 693 F.3d 251, 260 (1st Cir. 2012) (holding that "[t]he fact that the investments ultimately turned a profit does not make the purchases suitable when made"), citing *Eugene J. Erdos*, 47 S.E.C. 985, 988 n.10 (1983)("[R]ecommendations are not rendered suitable merely because they may 'result in profits to customers.'").

[221] Customers CM, RL, NJ, and RJ invested only in three-year term Debentures that matured in 2015.

[222] The nine customers who invested in seven-year Debentures, the earliest of which will mature in March 2019, are JB, DB, PB, SC, RE, NH, RS, JS, and MS.

limitation.[223] The reduction leaves the nine customers with a total of $906,314 currently invested in seven-year term Debentures. This money remains at risk of partial or total loss for another three years, according to the warnings contained in the Prospectus. Four other customers invested a total of $258,500 in four- and five-year Debentures that will mature as late as July 2017.[224]

The investors with the largest remaining exposure to the risk of having invested in the Debentures are JS and MS. The couple invested a total of $383,014 in two seven-year Debentures—equal to one-third of their net worth—that will not mature until mid-2019. Their investment principal will remain exposed for more than three years.

The Panel examined the record for potentially mitigating factors that might warrant lesser sanctions and found none. After considering all of the aggravating factors, and the lack of mitigating factors, the Panel imposes a unitary sanction for Escarcega's fraudulent misconduct and unsuitable recommendations and bars him in all capacities from associating with any member firm. Given the presence of aggravating factors and the absence of mitigating factors, the bar is appropriately remedial.[225] The bar will serve to deter other brokers from engaging in similar egregious misconduct with customers.[226] Escarcega is also ordered to disgorge the financial benefit from his misconduct as a fine in the amount of $52,270 (plus interest from February 6, 2013 until paid),[227] which is the amount of commissions paid by GWG for his sales of Debentures to the 18 customers.[228]

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[223] The five Arizona residents whose investments in seven-year term Debentures exceeded 10 percent of their net worth and whose investment amounts were reduced by GWG are JB, DB, PB, SC, and NH. GWG returned a total of $362,700 to them. CX-43.

[224] Customers MD, NZ, WJ, and SM invested in four- or five-year term Debentures that will mature as late as July 2017.

[225] *Kirlin Sec., Inc*., Exchange Act Release No. 61135, 2009 SEC LEXIS 4168, at *85-86 (Dec. 10, 2009) (affirming a bar imposed by FINRA where FINRA "appropriately considered" the relevant guidelines and concluding that the bar "will protect the market and investors from the risk of future violations . . . while also deterring others from engaging in the same serious misconduct.").

[226] *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005) ("Although general deterrence is not, by itself, sufficient justification for expulsion or suspension, we recognize that it may be considered as part of the overall remedial inquiry.").

[227] February 6, 2013, is the date of Escarcega's last sale of Debentures (to customer MD). Stip. ¶ 27. Prejudgment interest is a matter of discretion for an adjudicator. Where a violator has enjoyed access to funds over time as a result of his wrongdoing, requiring the violator to pay prejudgment interest is consistent with the equitable purpose of disgorgement. *SEC v. Hughes Capital Corp.*, 917 F. Supp. 1080, 1089-90 (D.N.J. 1996), *aff'd*, 124 F.3d 449 (3rd Cir. 1997).

[228] "Disgorgement is appropriate in all sales practice cases, even where an individual is barred, if, among other things, 'the respondent has retained ill-gotten gains.'" *Dep't of Enforcement v. Murphy*, No. 2005003610701, 2011 FINRA Discip. LEXIS 42, at *116 (NAC Oct. 20, 2011) (citing Guidelines at 10). *See Dep't of Enforcement v. Davidofsky*, No. 2008015934801, 2013 FINRA Discip. LEXIS 7, at *41-44 (NAC Apr. 26, 2013) (affirming Hearing Panel's order that respondent pay a fine as disgorgement representing the amount of respondent's ill-gotten gains).

B. Cause Five: Books and Records Violations

For recordkeeping violations of FINRA Rule 4511, the Guidelines recommend a fine of $1,000 to $15,000 and a suspension of up to 30 business days in any or all capacities for responsible individuals. In the case of egregious violations, the Guidelines recommend a fine ranging from $10,000 to $146,000 and consideration of a suspension of up to two years or a bar. In addition to the Principal Consideration, the Guidelines direct adjudicators to consider the nature and materiality of the inaccurate or misleading information in the firm records.[229]

The Panel finds that Escarcega's inflation of JB and DB's net worth and his failure to disclose to Center Street on account documents that they were engaging in a product switch helped qualify the customers to invest in the Debentures. Accordingly, we would fine Escarcega $5,000 and suspended him in all capacities for ten business days for the books and records violation. In light of the bar for Escarcega's fraudulent misconduct and unsuitable recommendations, however, the Panel declines to impose an additional sanction for the books and records violation.

VI. ORDER

Escarcega made fraudulent misrepresentations to seven customers in connection with their investments in the GWG Debentures, in willful violation of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010. He made unsuitable recommendations to 12 customers, in violation of NASD Rule 2310 and FINRA Rules 2111 and 2010. For these violations, Respondent David Joseph Escarcega is barred from associating with any member firm in any capacity and ordered to disgorge as a fine the amount of $52,270 (together with prejudgment interest from February 6, 2013, until paid) that GWG paid him in commissions for the sale of the Debentures to 18 customers.[230]

Enforcement did not prove by a preponderance of the evidence that Escarcega distributed misleading sales literature, in violation of NASD Rule 2210(d)(1)(A) and FINRA Rule 2010. Therefore, the Complaint's fourth cause of action is dismissed.

Because the Extended Hearing Panel finds that Escarcega made fraudulent misrepresentations to seven customers, as alleged in cause one, we dismiss cause two, which alleges, in the alternative, that Escarcega violated FINRA Rule 2010 by making misrepresentations about the Debentures.

Escarcega is ordered to pay the costs of the hearing in the amount of $5,267.67, which includes a $750 administrative fee.

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[229] Guidelines at 29.

[230] The prejudgment interest rate shall be the rate established for the underpayment of income taxes in Section 6621 of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), the same rate that is used for calculating interest on restitution awards. Guidelines at 11.

If this decision becomes FINRA's final disciplinary action, the bar will take immediate effect. The fine and assessed costs shall be due on a date set by FINRA, but not sooner than 30 days after this decision becomes FINRA's final disciplinary action in this proceeding.[231]

Michael J. Dixon
Hearing Officer
For the Extended Hearing Panel

[231] The Extended Hearing Panel has considered and rejects without discussion any other arguments made by the Parties that are inconsistent with this Decision.