NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. BERRY-SHINO SECURITIES, INC. (BD #38098) Scottsdale, AZ R. MATTHEW SHINO (CRD #1380293) Scottsdale, AZ Respondents.	Disciplinary Proceeding No. C3A030001 Hearing Officer – DMF **HEARING PANEL DECISION** December 10, 2003

Respondents (1) charged unfair and excessive commissions on retail agency transactions in listed options, in violation of Rule 2110; and (2) executed options transactions without having obtained required information and documentation from the customers, in violation of Rules 2860 and 2110. For charging unfair and excessive commissions, respondents are fined $50,000, jointly and severally, and the individual respondent is suspended in all principal capacities for 10 business days; for failing to obtain required information and documentation, respondents are fined $2,500, jointly and severally; and respondents are also ordered to pay hearing costs in the amount of $2,963.76. An additional charge that respondents did not return investor funds when an offering failed to satisfy its minimum sales contingency, in violation of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-9 and NASD Rule 2110, is dismissed.

Appearances

Jacqueline D. Whelan, Esq., Denver, CO, (Rory C. Flynn, Esq., Washington, DC, Of Counsel) for Complainant.

Michael S. Finkelstein, Esq. and Timothy Feil, Esq. for Respondents.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on May 30, 2003, alleging that respondents Berry-Shino Securities, Inc. ("BSSI") and R. Matthew Shino (1) charged unfair and excessive commissions on retail agency transactions in listed options, in violation of Rule 2110; (2) executed options transactions without having obtained required information and documentation from certain customers, in violation of Rules 2860 and 2110; and (3) did not return investor funds when an offering failed to satisfy its minimum sales contingency, in violation of Section 10(b) of the Securities Exchange Act, SEC Rule 10b-9 and NASD Rule 2110. Respondents filed an Answer contesting the charges and requested a hearing, which was held in New York, NY on September 29, 2003, before a Hearing Panel that included a Hearing Officer and two members of the District 10 Committee.[1]

II. Respondents

BSSI is a small broker-dealer (currently having about 35 registered persons and less than $100,000 net capital) with its headquarters in Phoenix, Arizona and a branch office in New York, New York. Shino has served as president of BSSI since the firm's

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[1] At the hearing, Enforcement offered the testimony of an NASD examiner and respondents offered the testimony of Shino. The parties also offered stipulations of fact ("Stip."), Enforcement offered Complainant's Exhibits ("CX") 1-31A, all of which were admitted, and respondents offered Respondents' Exhibits ("RX") 1-9 and 11, which were admitted (RX 10 was not offered). Respondents also offered RX 12 and 13, which were initially admitted provisionally, subject to Enforcement's post-hearing review, because they had not been included in respondents' pre-hearing submission. Later in the hearing, however, the parties agreed that, instead of Enforcement reviewing RX 12 and 13 following the hearing, they would attempt to agree upon and submit an additional summary exhibit. The parties were not able to agree, however; instead, respondents submitted a post-hearing memorandum and a proposed summary exhibit, and Enforcement submitted a post-hearing memorandum stating that it had "not verified" some of the information in the exhibit, but "accept[ed] its accuracy for the purpose of argument." The Hearing Officer, therefore, will admit respondents' proposed post-hearing exhibit, but notes that it is entitled to limited weight because the completeness and accuracy of some of the data included in the exhibit in summary form cannot not be verified from the record.

inception in 1995, and also serves as the firm's chief compliance officer, senior registered options principal, compliance registered options principal, and municipal securities principal, and at the relevant time also served as the firm's financial and operations principal. BSSI has been a member of NASD since 1995; Shino has been in the securities industry since at least 1989. Neither BSSI nor Shino has any prior disciplinary history. (Tr. 82-83, 218-20, 240-42; CX 1-2.)

III. Options Trades

A. Commissions

1. Facts

In 1999, BSSI entered into negotiations with certain principals of then-NASD member ISG Solid Capital Markets to join BSSI. Ultimately those negotiations proved unsuccessful. ISG, however, had a branch office in Frankfurt, Germany. The staff of that office transferred their registrations to BSSI, opened a BSSI branch office in Frankfurt, and brought with them to BSSI an ongoing arrangement with three European money managers – Wertpapierhandelsagentur Coskun, Condis GmbH and DBV GmbH.[2] (Tr. 84, 86-88, 92; CX 4-6.)

The money managers had written agreements with European nationals giving the money managers powers of attorney to effect options trades in United States markets on behalf of the customers. The agreements provided that the money managers could charge fees ranging from $95 to $150 for each options contract purchased; the customers were not charged any fees on sales. Before BSSI's branch opened, the European customers had accounts with ISG through which the money managers placed the trades. When the former ISG personnel opened BSSI's Frankfurt branch, the customers transferred their

[2] Coskun and Condis were German entities; DBV was Swiss. (CX 4-6.)

accounts to BSSI and, beginning in mid-1999, the money managers placed the trades through BSSI, in the same manner as they had with ISG. (Tr. 13, 86, 90-92; CX 4-6.)

The arrangement was formalized in agreements between BSSI and the money managers. The agreements provided that the customers would open BSSI accounts; that BSSI would collect the fee that the customer had agreed to pay the money manager (described in the agreements as "commissions") from the customer's account for each trade; and that BSSI would "pay [the money manager] a rebate equal to the commission authorized by" the customer, less a portion ($15 or $20 per contract) that BSSI would retain.[3] The agreements also provided that each customer would "receive a descriptive document … that discloses what compensation is being provided to [the money manager] with respect to activity in their accounts with [BSSI], and each [money manager's] Client shall provide written acknowledgment of such compensation arrangement."[4] (CX 4-6.)

In accordance with these agreements, using their powers of attorney, the money managers placed orders with BSSI to purchase and sell options (generally calls) in the customers' accounts. Initially, they placed the orders with BSSI's Frankfurt branch, which relayed the orders to BSSI's trading desk in Arizona, where they were executed through BSSI's clearing firm. Later, after some of BSSI's Frankfurt branch office personnel left BSSI and associated with another NASD member firm, the money managers placed the orders with BSSI's trading desk in Arizona or directly with BSSI's clearing firm. BSSI executed the orders, collected the commissions, paid most of that

[3] Shino testified that, in fact, the amounts retained by BSSI were generally somewhat less than the amounts set forth in the agreement, ranging from $12 to $15 in most cases. (Tr. 109, 114, 157-59, 215-17; CX 4-6.)

[4] Enforcement did not contend, or offer any evidence, that the customers did not receive or acknowledge this disclosure.

amount to the money managers and retained a portion for itself. BSSI also sent confirmations directly to the customers for all transactions, disclosing the full amounts of the commissions as "transaction charges." (CX 3A, 31 at 7-11; RX 4, 5; Tr. 128, 153, 238-39.)

Because the customers were charged a flat fee per contract, the commission rates charged to the customers varied greatly as a percentage of the principal amount of the customer's investment, depending upon the cost of the contracts purchased.[5] In this case, Enforcement focused on 1,039 purchase transactions in which the customers were charged commissions ranging from 10% to 60% of the principal amounts of the investments. The transactions involved the purchase of from 1 to 200 options contracts for principal amounts of less than $1,000 to more than $100,000, but mostly $10,000 or less. In total, the customers were charged more than $2.3 million in commissions for those transactions. In accordance with its agreements with the money managers, BSSI remitted most of this amount to the money managers, but under the agreements it was entitled to retain approximately $266,000 on the trades at issue.[6] (CX 3, 29; Tr. 143.)

Shino discussed BSSI's role in collecting and forwarding the commissions to the money managers, including the amount of commissions that the money managers were charging the European customers, with ISG's chief executive, as well as the money managers and their German attorney. All of them assured Shino that the money managers' arrangement with BSSI and the commissions they were charging the

[5] For example, in transaction 1 on CX 3, the customer purchased 26 contracts at $250 per contract, for a total of $6,500, and was charged a $150 commission for each contract, totaling $3,900, or 60% of the principal amount of the purchase. In contrast, in transaction 450, the customer also purchased 26 contracts and was charged a commission of $150 per contract, but because each contract cost $400, the total commission of $3,600 was only 37.6% of the $10,400 principal amount of the purchase.

[6] According to respondents' post-hearing exhibit, BSSI actually received approximately $250,000 on the trades.

customers were allowable, and pointed out that BSSI was simply continuing ISG's business with the money managers. The parties stipulated that Shino "understood that this commission/transaction fee practice was customary and legal within Germany with respect to the amounts charged and the remittance practice," and during the hearing Enforcement counsel stipulated "that the practices of the German money managers, the manner in which they handled accounts and the compensation which they received for handling the account[s] [were] permissible within Germany and consistent with the German practice, and to the extent Switzerland was involved, permissible in Swiss practice." (Tr. 81, 93-95, 102, 142; RX 1; Stip. 66, 67.)

At some point, Shino also discussed BSSI's arrangements with the money managers with BSSI's core examiner at NASD's District 3 office in Denver.[7] The examiner testified that he and Shino "discussed the foreign money managers, [Shino] discussed the whole situation, and I never heard of the situation before, so I was basically confused, and I didn't know what to tell him at this point." The examiner was concerned about the size of the total commissions, however, and therefore called the staff of the Chicago Board Options Exchange, where the transactions were effected. He asked whether the CBOE had a rule limiting commissions on options trades, and was told that it did not. In addition, the examiner discussed the issue with his supervisor, who was also concerned. They decided to gather more information, but in the meantime, they did not tell Shino either that the practice was allowable, or that it was prohibited. The examiner

[7] The examiner thought the discussions began when he spoke to Shino in the course of preparing for BSSI's routine examination in early 2000, while Shino was certain they had discussed the arrangement earlier, in Summer 1999. (Tr. 28-29, 112.) It is not necessary for purposes of this decision to determine precisely when the discussions began. The Panel notes, however, that the examiner testified that, as a general matter, Shino "called in a lot more than any other firm, he did have a lot of questions. I would say that some firms don't call in ever, but [Shino] called in maybe once or twice [a week] with questions, so we dealt back and forth certainly." (Tr. 27.)

did, however, suggest to Shino that he obtain an opinion from an attorney, or seek an opinion from NASD's General Counsel, which Shino did not do.[8] (Tr. 13-15, 30, 34, 114-15, 227-28.)

The transactions cited by Enforcement took place between July 1999 and July 2000. By February 2000, BSSI closed its Frankfurt office and the money managers worked out arrangements with BSSI's clearing firm allowing them to place orders directly with that firm, paying only the clearing firm's charges. By about August 2000, BSSI ceased its involvement in the money managers' transactions. (Stip. 54-56; CX 31 at 7-11.)

The staff's investigation, however, continued. They attempted without success to discuss the commissions issue with the examiners who had been responsible for examining ISG, but learned they had left NASD. They also held conferences with other NASD member firms "to see if there was a practice they were aware of." As a result, "time slowly went by" as the staff was "trying to figure out is this okay to do." Ultimately, the staff concluded that BSSI was responsible for charging excessive commissions, and initiated this proceeding in May 2003. (Tr. 36, 55.)

2. <u>Discussion</u>

Enforcement alleged that BSSI, under Shino's direction, charged unfair and excessive commissions to the European customers in 1,039 options purchase transactions,

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[8] Shino acknowledged that the examiner "did ask me if I could get [a] written opinion of counsel," but explained "opinions of counsel are not cheap, and for a small firm, you know, to get them to go out and do research and to render a written opinion, I didn't know how much that was going to cost." He did consult with an attorney who "could not find any rules that we were in open violation of," but did not undertake the work needed to render a formal opinion. (Tr. 117.) He "made an attempt" to contact someone at the SEC or in NASD's Office of General Counsel, but concluded from his efforts that "it is … difficult to get an opinion from any regulator about anything." (Tr. 115-16.)

in violation of Rule 2110.[9] Although no NASD rule specifically addresses commissions for options transactions, in Atlanta-One, Inc., 52 S.E.C. 161 (1995), the SEC held that charging excessive commissions on options trades violates the obligation to "observe high standards of commercial honor and just and equitable principles of trade" set forth in Rule 2110.

The SEC found that, although there are no hard and fast standards for determining whether options commissions are excessive, "NASD's guidelines in its mark-up policy provide at least general guidance as to the realm of acceptable prices that may be charged retail customers." Those guidelines, as set forth in Rule 2440, provide that in agency transactions, an NASD member:

> shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.

In addition, the SEC explained: "Implicit in the concept of fair pricing of commissions is the notion that commissions must not be so excessive as to make it unlikely that the customer's investment could appreciate sufficiently to compensate the customer for the commission and generate a profit." 52 S.E.C. at 164.

As in this case, Atlanta-One "charged a high, flat dollar amount, from $50 to $89 per contract, on a round-trip basis," leading to commissions that the SEC calculated as

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[9] Shino did not dispute his personal liability for any violations by BSSI. He was BSSI's president, chief compliance officer, senior registered options principal, and compliance registered options principal. He approved the arrangements with the money managers and approved all of the transactions at issue.

"represent[ing] between 14.20% and 89% of the customers' investments."[10] The SEC found that at least the upper range of these commissions was unfair and excessive, explaining: "Thus, in 71% of the transactions, the customer's position would have had to appreciate by 40% or more in order for the customer to realize a profit net of the equity investment and transaction cost." Further, the SEC pointed out:

> The level of commissions charged by [the respondents] had obvious adverse customer impact. Of the options at issue here, only 24% were ultimately sold at a profit, while 38% were sold at a loss and 38% expired worthless. In those cases where options expired worthless, the extraordinarily high level of commissions exacerbated the extent of the customer loss. In those cases where the customer was able to minimize the extent of the financial damage by selling at a loss, the size of the commissions had a disproportionate impact on the amount of the loss.

52 S.E.C. at 162, 165.

Respondents point out that the SEC described the investments in Atlanta-One as "deep out-of-the-money foreign currency options" that were "highly speculative investments with an extremely low potential for profitable return." 52 S.E.C. at 162. In contrast, the investments in this case generally involved purchases of long-term options in blue-chip American companies – "in the money or close to the money leads, large cap, highly liquid stocks" that "were usually out nine months to a year, up to maybe a year and a half or even two on the outside, and they were all bigger stocks, generally speaking," according to Shino, and confirmed by Enforcement's list of trades. (Tr. 234; CX 3.)

Further, Shino testified that he tracked the performance of the German customers' accounts, and that, in spite of the size of the commissions, "there were many of the

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[10] The SEC explained that by "round-trip" it meant that, as in this case, "the up-front fee included the commission for both the purchase and sale of the option, regardless whether the option ultimately was sold or expired worthless." 52 S.E.C. at 162.

accounts, particularly in ’99, that were extremely profitable, I would say probably upwards of 80 percent of them, and that is profitable net of transaction [costs]. … [M]aybe a little bit lower in 2000. Maybe 60 or 70%.” (Tr. 144, 148-50; CX 6-7; Stip. 68-69.) Shino also testified that, based on his analysis of the 38 most active accounts:

> I would estimate … less than ten percent [of the options purchased by the German customers] expired worthless. … [I]f you have an account managed by a professional options money manager, they are not going to let the position go to zero. Why would they? It doesn’t make any sense, particularly given the fact that they are not buying … way out of the money options. They were buying these … to trade.

(Tr. 181.)

Nevertheless, Shino himself recognized that the total commissions BSSI collected were very high. In 829 of the 1,039 transactions cited by Enforcement, the commission was 30% or more. In testimony that he gave during NASD’s investigation, Shino stated for options trades by its other customers, BSSI charged, at most, 7% on opening transactions and 7% on closing transaction, as negotiated with the customer. (CX 31 at 15.) Thus, under BSSI’s own standards, the commissions it collected on 829 transactions for the accounts of the European customers were more than twice as much as the maximum commission it charged its other customers, even taking into consideration that the European customers paid round-trip commissions on opening transactions and were not charged additional commissions on sales.[11]

Respondents’ argue, however, that, in determining whether the commissions were excessive, BSSI should only be held accountable for the portion of the total commissions

[11] In Atlanta-One, the respondents also charged a round trip commission, but in analyzing whether those commissions were excessive, the SEC did not make an adjustment for the fact that no additional commissions were charged on sales. Respondents argue that this aspect of Atlanta-One is dictum that does not bind the Panel in this case. For reasons explained below, however, the Hearing Panel has determined that the round-trip commissions of 30% or more charged in 829 transactions were unfair and excessive, even considering that no commissions were charged on sales.

that it retained, because the money managers received the lion's share. Furthermore, the amounts that went to the money managers were based upon agreements between the customers and the money managers that the parties stipulated were allowable under applicable European law, and the customers were advised that BSSI would collect those amounts.[12] Respondents argue that BSSI's share of the commissions was less than 10% of the investment principal in every instance, and was not excessive taking into consideration all relevant factors, in accordance with Rule 2440. In fact, respondents assert that if BSSI had simply charged its normal commission of about 5% on both purchases and sales, rather than taking only a share of the commissions that the customers had agreed to pay the money managers, it would have earned, and the customers would have paid, considerably more on the transactions.

Enforcement, however, argues that under U.S. Securities Clearing Corp., 52 S.E.C. 92 (1994), the fairness of the commissions charged by BSSI must be based on the full amount it charged, not just the amount it retained. In U.S. Securities Clearing Corp., a German entity (its precise legal status under German law was unclear) solicited orders from German nationals to purchase stocks in the American market. The customers opened accounts with U.S. Securities Clearing Corp. ("USSCC"), an American broker-dealer that was a member of NASD, to effect the transactions. The German entity transmitted trading instructions for the orders it had solicited to USSCC, which filled them from its stock inventory. USSCC charged the customers substantial markups on the transactions, remitting 90% to the German entity.

[12] BSSI did not, however, disclose to the customers that it would retain a portion of the commissions payable to the money managers, because Shino thought the division of the agreed-upon commission was between BSSI and the money managers, and should not have been of concern to the customers. (CX 31 at 51.)

The SEC affirmed NASD's determination that the USSCC charged excessive markups in more than 300 of these transactions. The SEC found, first, that NASD had jurisdiction even though the transactions were solicited by the German entity in Germany, because the transactions involved American securities; were effected by USSCC, an American broker-dealer; were executed and cleared in the United States; were paid for with funds transferred to the United States; and were confirmed by confirmations mailed from the United States to Germany. Next, the SEC rejected the argument that the German nationals were not customers of USSCC, noting that each customer had opened an account with USSCC through which the trades were effected, and that USSCC retained a portion of the markup on each trade. Finally, the SEC rejected USSCC's argument that it was not responsible for the size of the markups because the German entity set the prices for the transactions, stating: "[USSCC] cannot contract away its pricing responsibilities under the United States securities laws and the NASD's rules. … The NASD's rules require that prices in transactions with customers be fair." 52 S.E.C. at 98.

In light of <u>U.S. Securities Clearing Corp</u>., it is clear that the agreements between the customers and the money managers could not override BSSI's responsibilities to its customers under NASD's rules. As an NASD member, BSSI had an independent obligation to charge and collect only fair commissions, and, as the SEC explained in <u>U.S. Securities Clearing Corp</u>., it could not "contract away its pricing responsibilities under the United States securities laws and the NASD's rules."

BSSI charged the commissions; collected them; kept a portion; and "rebated" the balance, all in accordance with its agreements with the money managers.[13] The disclosure of the amount of the commissions to the customers did not make them fair. NASD's Mark-Up Policy, as incorporated in IM-2440, provides:

> Any disclosure to the customer, before the transaction is effected, which would indicate … the amount of commission charged in an agency transaction … is a factor to be considered. Disclosure itself, however, does not justify a commission or mark-up which is unfair or excessive in light of all other relevant circumstances.

Moreover, there is no evidence that BSSI disclosed to the customers that in many instances they were being charged commissions that substantially exceeded the maximum commissions that BSSI charged its other customers, and that those commissions might exceed the amounts allowable under NASD rules.

The issue, then, is whether the total commissions charged by BSSI on the 1,039 transactions cited by Enforcement were unfair and excessive. Those commissions ranged as low as 10%, but in 829 transactions exceeded 30%. In DBCC No. 2 v. Atlanta-One, Inc., No. C02940018, 1995 NASD Discip. LEXIS 216 (NBCC June 26, 1995), a subsequent disciplinary proceeding against the same firm involved in the SEC's Atlanta-One decision, the National Business Conduct Committee determined, based on its reading of the SEC's decision, that round-trip commissions of 23% to 65% on foreign currency options were "inherently excessive or 'grossly disproportionate'" under the SEC's Atlanta-One analysis. The NBCC also concluded, however, that the SEC's

[13] Respondents argue that under Rule 1060, they were allowed to collect and remit the amounts that the customers had agreed to pay the money managers. Rule 1060, which defines "Persons Exempt from Registration" with NASD, provides that member firms "may pay to non-registered foreign persons transaction-related compensation based upon the business of customers they direct to member firms" if certain conditions are met. Nothing in Rule 1060, however, suggests that a member may ignore the amounts paid to foreign persons in determining whether the commissions it charges are fair, and the Hearing Panel rejects any such interpretation of the rule.

decision required a more thorough analysis of all relevant factors in order to determine whether commissions of 18% or less were excessive. The NBCC therefore remanded the case to the District Business Conduct Committee to undertake such an analysis. In remanding the case, however, the NBCC instructed: "[T]he DBCC could determine that commissions above a particular percent are clearly unfair … without specifying that all commissions below that percent are permissible." 1995 NASD Discip. LEXIS 216 at *32-34, 39 n. 8.

Applying the NBCC's guidance to this case, the Hearing Panel finds that the commissions of more than 30% that BSSI charged in 829 transactions were clearly unfair and excessive. As explained above, those commissions represented more than twice the maximum commissions that BSSI charged its other customers on options trades. There is no evidence of any circumstances that would reasonably justify commissions of that magnitude under the factors cited in Rule 2440. The transactions involved options traded on a national exchange and BSSI incurred no unusual expense in executing the orders beyond normal charges from its clearing firm. The volume of transactions required BSSI to exercise some trading expertise, but not of a degree that could justify commissions more than twice as high as the maximum it charged its other customers, and BSSI did not show that either it or the money managers exercised specialized knowledge of the options in question or the market for those options that could have justified commissions of 30% to 60%.[14] Moreover, the commissions were not based upon BSSI's assessment of the factors in Rule 2440; instead, BSSI simply imposed commissions at a level established by the money managers, in exchange for a share. In U.S. Securities Clearing Corp., the SEC

[14] See Atlanta-One, 52 S.E.C. at 166: "No specific showing was made concerning the expertise brought to bear by [the respondents] …."

held that an NASD member may not delegate its responsibility to charge fair commissions in that manner.

Furthermore, respondents knew that charging commissions of 30% and more would have a significant impact on the likelihood that the customers' investments would appreciate. During his investigative testimony, Shino characterized the fact that some of the customers earned profits on their options as "incredible" and "amazing," as indeed it was. (Tr. 181, 182, 190.) But although Shino's contemporaneous calculations indicated that many customers had earned profits on trades, the same calculations disclosed that many others had incurred losses, some of them substantial. As the SEC observed in its Atlanta-One decision, the magnitude of the commissions had a "disproportionate impact on the amount of the loss."[15] (RX 6, 7.)

Under both the SEC's and the NBCC's Atlanta-One decisions, no deeper analysis of those transactions is required. The Hearing Panel, therefore, concludes that in the 829 transactions in which BSSI charged commissions of 30% and higher, respondents violated Rule 2110.

In most of the remaining 210 transactions cited by Enforcement, BSSI charged commissions of 10% to 18%.[16] In its order remanding its Atlanta-One case to the DBCC, the NBCC suggested that to evaluate commissions in that range, a deeper analysis of all relevant factors was required. In this case, those factors might include the facts that the customers agreed to the commissions; that the commissions were "round-trip,"

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[15] Moreover, it is by no means clear that Shino's calculations accurately reflect the longer term outcomes of the customers' investments. When he made his calculations, he took into consideration only the results of purchases that had been closed out as of that date; in many accounts, however, there were a substantial number of open positions when Shino made his calculations. It is not possible to determine from the evidence in the record whether, in the end, the customers had gains or losses on those positions.

[16] In just 17 of the 210 transactions, the commissions were between 18.1% and 27.9%.

particularly if most of the positions were sold, rather than allowed to expire; and that the customers apparently earned profits on some of the transactions, even taking the commissions into account.[17]

Instead of attempting such an analysis, particularly given the limited evidence in the record, and following the NBCC's suggestion in its Atlanta-One decision, the Hearing Panel will rest its decision on the 829 transactions in which the commissions exceeded 30%. The Hearing Panel does not affirmatively find that the commissions charged in the remaining transactions were fair and reasonable, but it does not base its finding that respondents charged unfair and excessive commissions in violation of Rule 2110 on those transactions.

B. Documentation

1. Facts

As explained above, the options trades were effected in the European customers' BSSI accounts, which had been transferred to BSSI from ISG when BSSI opened its Frankfurt branch office. Shino acknowledged that when the accounts were transferred, BSSI had to obtain certain information and documentation that Rule 2860 requires from each customer that is approved for options trading. (Tr. 120-21.)

Shino directed BSSI's Frankfurt office personnel to obtain the required documentation from the customers. The parties stipulated that BSSI obtained documentation for 265 of the 295 German investor accounts within the time periods specified under Rule 2860, but not for the remaining 30 accounts. The parties further stipulated that BSSI relied upon previously or contemporaneously-executed ISG

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[17] In its Atlanta-One remand order, the NBCC said: "We also note that the record does not contain clear evidence as to the numbers of customers that profited in their transactions, and that the SEC appears to have found this evidence helpful in [its Atlanta-One decision]." 1995 NASD Discip. LEXIS 216, at *34.

documents for nine of those accounts, and obtained BSSI documents for seven others after the time periods specified in Rule 2860, but never obtained the required documentation for the remaining 14 accounts. (Stip. 73; Tr. 133-34; CX 11-13.)

When BSSI did not receive timely documentation for all the accounts, Shino exerted pressure on the Frankfurt office, including withholding commissions, but for a time he allowed trading in the accounts. He hesitated to restrict trading in the accounts, because the accounts had been opened and traded at ISG, and he was concerned that BSSI could be liable from losses the clients might incur while the accounts were restricted. He was also influenced by the fact that the accounts were being traded by professional money managers, not by the customers themselves. By September 1999, however BSSI restricted the accounts for which it did not have required documentation. In those accounts, the money managers were allowed to close existing positions, but could not open new positions. (Tr. 121-25, 130, 133-34; CX 11-13; Stip. 73.)

2. <u>Discussion</u>

Rule 2860(b)(16)(B) requires member firms, in approving a customer's account for options trading, to "exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives," and Rule 2860(b)(16)(D) requires member firms to "obtain from the customer a written agreement that the customer is aware of and agrees to be bound by the Rules of the Association applicable to the trading of option contracts," as well as certain other information. In spite of Shino's efforts, the parties agreed that BSSI allowed trading in 30, or approximately 10%, of the 295 European customers' accounts without having obtained all the required documentation in a timely manner. Therefore, the Panel determined that respondents violated Rule 2860 and 2110, as charged.

IV. Private Placement

A. Facts

In 1999, BSSI managed a private placement of common stock issued by Hunter Wise Financial Group, LLC. According to the offering statement, the offering would be canceled and deposited funds would be returned to investors if the offering failed to raise a minimum of $2,300,000 by January 31, 2000, unless that date was extended. The offering statement did not disclose that any purchases in the offering by affiliates of either Hunter Wise or BSSI could be counted towards the satisfaction of the minimum sales contingency. (Stip. 12, 13; CX 14, 15.)

The offering raised $2,300,000 by mid-January 2000 from approximately 22 investors. One of the investors, in the amount of $100,000, was the IH Family Trust, the trustees of which were IH and MH. IH was a director and shareholder of BSSI at the time of the purchase. TJ, another director and shareholder of BSSI, also invested $100,000. As of January 31, 2000, the original deadline in the offering statement, if the funds invested by the IH Family Trust and TJ were not counted, the offering had not raised the $2,300,000 minimum. On January 31, the offering period was extended until March 31, 2000, in accordance with the offering statement. During February 2000, the offering raised an additional $300,000 from investors who were not affiliated with either Hunter Wise or BSSI. (Stip. 14, 57; CX 16-20; Tr. 194-201, 203-05, 208.)

B. Discussion

The third cause of the Complaint was headed "Section 10(b) of the Securities Exchange Act, SEC Rule 10b-9 and NASD Conduct Rule 2110, Failure to Return Investor Funds When Offering Failed to Meet Minimum Sales Contingency, by Respondents BSSI and Shino." It alleged that the funds invested by the IH Family Trust and TJ should not have been counted towards the minimum, because those investors were affiliates of BSSI and the offering statement did not disclose that investments by affiliates could be counted.[18] As a result, the Complaint charged, "only $2,100,000 [that could properly be counted toward the minimum] was received by the contingency date and the minimum sales contingency was not met. Investor funds should have been returned to the investors consistent with the representations in the offering memorandum." By not returning the funds, the Complaint charged, respondents violated SEC Rule 10b-9 and NASD Rule 2110. In its pre-hearing memorandum, Enforcement confirmed that its theory of liability against respondents was based on the failure to return investor funds when the offering did not raise the minimum by the deadline in the offering statement.

In its closing argument, however, Enforcement's position changed. Enforcement acknowledged that, in fact, the offering was extended to March 31, 2000, in accordance with the offering statement. Enforcement also agreed that, even if the IH Family Trust and TJ investments were not counted, the offering satisfied the minimum sales contingency within the extended deadline. Accordingly, Enforcement conceded that

[18] See Nicholas P. Howard, Initial Decisions Rel. No. 138, 1999 SEC LEXIS 577, at *35 (Mar. 24, 1999) ("The purpose of Rule 10b-9 is not only to assure that the issuer has sufficient funds to go forward with its business plan but also to give investors some reasonable indication that they are paying a fair market price; closing without bona fide sales to the public of the required minimum number of shares is therefore fraudulent.").

BSSI and Shino did not violate SEC Rule 10b-9 and NASD Rule 2110 by failing to return investor funds.[19] (Tr. 265.)

In its closing, however, Enforcement offered a new theory of liability against respondents. In accordance with the offering agreement, the funds raised from investors were deposited in an escrow account. Enforcement argued that the escrow was broken and the funds disbursed improperly in January 2000, before the minimum amount of the offering had been raised, if the funds invested by the IH Family Trust and TJ were not counted.

No such charge was set forth in the Complaint. NASD Rule 9212(a)(1) provides: "The Complaint shall specify in reasonable detail the conduct alleged to constitute the violative activity and the rule, regulation or statutory provision the Respondent is alleged to be violating or to have violated." The third cause of the Complaint in this case did not mention the escrow account or the distribution of funds from that account, or refer to SEC Rule 15c2-4, which governs the escrow obligations of broker-dealers and serves as the basis for finding violations based on premature distribution of escrowed funds. See e.g., DBCC No. 8 v. Mains, No. C8A950016, 1997 NASD Discip. LEXIS 3, at *21 (NBCC Jan. 3, 1997) ("the Firm, acting through Mains, contravened SEC Rule 15c2-4 when it withdrew, or caused to be withdrawn, funds from the escrow account … prior to the minimum number of units being sold in bona fide transactions").

Even if a charge is not clearly articulated in the Complaint, it may be adequately clarified during the pre-hearing process and a respondent may be held liable if it is clear that the respondent had adequate notice of the charge and a fair chance to defend.

[19] In light of this concession, it was unnecessary for the Panel to determine whether the sales to the IH Family Trust and TJ were, or were not, bona fide sales that could be counted toward the minimum sales contingency under SEC Rule 10b-9.

Indeed, Rule 9212(b) authorizes the Hearing Officer to permit an amendment during or after the hearing "so as to make the complaint conform to the evidence presented," after considering whether Enforcement "has shown good cause for the amendment and whether any Respondent will suffer any unfair prejudice if the amendment is allowed."

In this case, Enforcement did not formally move to amend the Complaint to add the escrow violation charge, but even if it had done so, the motion would have been denied, because Enforcement did not demonstrate good cause for failing to assert that charge until its closing argument. The record establishes that Enforcement was aware of the relevant facts well before the hearing, so it could have amended the Complaint in a timely manner. In contrast, respondents would suffer unfair prejudice if Enforcement were allowed to, in effect, amend the Complaint in its closing argument, because until then respondents were focused on defending against the charge in the Complaint, which, as Enforcement conceded, they did successfully.

Accordingly, the Hearing Panel finds that respondents did not violate SEC Rule 10b-9 and NASD Rule 2110 by not returning investor funds when the offering failed to meet the minimum sales contingency. Therefore, that charge will be dismissed. The Hearing Panel declines to consider a charge, not included in the Complaint, that respondents prematurely broke the escrow account and distributed the proceeds.

V. <u>Sanctions</u>

A. <u>Excessive Commissions</u>

For the excessive commissions, Enforcement requested that the respondents be fined $15,000 to $20,000, jointly and severally, plus, as "disgorgement," approximately $266,000 more, which Enforcement calculated as BSSI's share of the commissions charged in the 1,039 transactions it cited, for a total fine of $281,000 to $286,000.[20] Enforcement also requested that Shino be suspended in all principal capacities for 90 days. Because the European customers "agreed to these charges," Enforcement did not request that respondents be required to pay restitution. (Tr. 271.)

For excessive commission violations, the Sanction Guidelines recommend a fine of $5,000 to $100,000 plus (if restitution is not ordered) the gross amount of the excessive commissions. In addition, the Guidelines recommend that Adjudicators consider suspending the responsible individual for up to 30 business days, or, in egregious cases, consider a longer suspension or a bar for the individual and a suspension or expulsion of the firm. NASD Sanction Guidelines at 98 (2001 ed.).

The Hearing Panel concludes that the sanctions requested by Enforcement are too severe under the circumstances of this case, and would be punitive, rather than remedial. The violation was not egregious. BSSI and Shino did not establish the arrangement with the money managers, but rather inherited it from another NASD member. Shino confirmed that the agreements between the customers and the money managers, including the amount of the commissions, were permissible under relevant European laws. He also disclosed BSSI's arrangement with the money managers to NASD staff, who were not immediately able to advise him that it violated any rules. Having had an opportunity to observe Shino testify, the Panel found that he entered into the arrangement with the

[20] "The purpose of disgorgement is to deprive a person of 'ill- gotten gains' and prevent unjust enrichment." Hateley v. SEC, 8 F.3d 653, 655 (9th Cir. 1993), (quoting SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991)).

money managers under the good faith belief that it was allowable. Enforcement agreed that respondents' violation was, at most, negligent, not intentional or reckless.[21]

Respondents were not, however, completely blameless. BSSI had an independent obligation to determine that its activities comported with NASD rules; it could not merely rely on the fact that ISG or other broker-dealers had engaged in similar activities without facing disciplinary charges. There were red flags. Shino recognized that the commissions were very high, more than twice what BSSI charged its other customers, and that it was "incredible" and "amazing" that some of the customers earned profits on the trades in spite of the commissions, yet he placed the trades, collected the funds, took BSSI's share, and remitted the balance to the money managers. And, even though the NASD examiner advised him to seek an opinion from an attorney or from NASD's General Counsel, Shino failed to do so. In light of all these factors, the Panel concludes that appropriate sanctions would be in the mid-range of the Guidelines' recommendations for non-egregious violations.

The Hearing Panel also concludes that "disgorgement" is not appropriate in this case for several reasons. First, Enforcement's disgorgement calculation was based on the amounts to which BSSI was entitled under its agreements with the money managers, $15 to $20 per contract, but Shino testified that, in fact, BSSI retained less, $12 to $15 per contract, on most transactions. According to respondents' post-hearing exhibit, BSSI's gross commissions for the 1,039 transactions were approximately $250,000, a calculation that Enforcement indicated it was "willing to accept" in its post-hearing memorandum.

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[21] Looking to other considerations set forth in the Sanction Guidelines, the Hearing Panel notes that the NASD examiner testified that respondents cooperated fully in the investigation, and, based on the examiner's testimony regarding his interactions with BSSI, it appears that "the misconduct at issue was aberrant or not otherwise reflective of the firm's historical compliance record." Sanction Guidelines at 10.

Even the $250,000 calculation is too high, however, because it includes all 1,039 transactions cited in its Complaint. The Panel's violation finding, however, is limited to 829 transactions in which the commissions were 30% or more.

More significantly, disgorgement "may be ordered only against those who received … unjust enrichment,"[22] and the amount of disgorgement "must be reasonable, i.e., approximately equal to the unjust enrichment."[23] The commissions of 30% and more that BSSI charged in 829 transactions were excessive under NASD standards, but BSSI remitted most of those commissions to the money managers, and Enforcement concedes that the money managers were entitled to those amounts under agreements with the customers that were allowable under applicable European laws. According to Enforcement's calculations, the portion of the commissions BSSI was entitled to retain on the 829 transactions amounted to just 3.16% to 8% of the investment principal, on a round trip basis.[24] It appears that if BSSI had charged its normal commissions, it would have received considerably more.

The facts of this case are unique. The violation arises out of BSSI's good faith involvement in collecting commissions that, although allowable under European laws, were unfair and excessive under NASD rules. BSSI's share of the commissions, however, was not excessive, and the money managers were also entitled to the amounts they received. In these extraordinary circumstances, the Panel finds no unjust enrichment and, therefore, concludes that disgorgement is not an appropriate sanction.

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[22] Kenneth L. Lucas, 51 S.E.C. 1041, 1046 (1994).

[23] Hateley v. SEC,8 F.3d at 656.

[24] As explained above, for many transactions, BSSI actually retained less than the amount to which it was entitled under the agreements with the money managers.

The Hearing Panel also notes that BSSI is a small firm, with less than $100,000 net capital, and that Shino holds many critical positions in the firm. The Sanction Guidelines advise: "When applying these principles and crafting appropriately remedial sanctions, Adjudicators should consider firm size with a view toward ensuring that the sanctions imposed are not punitive." NASD Sanction Guidelines at 3.[25] Imposing a fine of more than $250,000 and a 90-day suspension of Shino, as Enforcement requests, would threaten the viability of BSSI, which would be punitive under the facts of this case.[26]

Taking all these factors into consideration, the Hearing Panel finds that a joint and several fine of $50,000, together with a 10 business day suspension for Shino in all principal capacities, will fully accomplish NASD's remedial goals.

B. Failure to Obtain Required Documentation

For the failure to obtain required information and documentation, Enforcement requested that respondents be fined an additional $2,500. The applicable Guidelines appear to be those for recordkeeping violations, which recommend that Adjudicators impose a fine of $1,000 to $10,000, and consider a suspension of up to 30 business days for the firm and the responsible individual, or in egregious cases, a longer suspension or a bar or expulsion. Sanction Guidelines at 34.

The Hearing Panel agrees that the fine requested by Enforcement is appropriate. This was not an egregious violation. Respondents recognized that BSSI needed to have

[25] The Guidelines indicate that it is appropriate to consider firm size for violations involving negligence, but is not necessarily appropriate if the violations involve "fraudulent, willful and/or reckless misconduct." In this case, for reasons explained above, respondents' conduct was, at most, negligent.

[26] If necessary to accomplish NASD's remedial goals, it may be appropriate to order disgorgement that exceeds a respondent firm's net capital or ability to pay, but, for reasons stated, that is not appropriate here.

the information and documentation required under Rule 2860 and they made a good faith effort to obtain it. They obtained it in a timely manner from approximately 90% of the customers. They pressured the personnel in the Frankfurt branch to obtain documentation from the remaining customers, and ultimately restricted those accounts. Therefore, a fine at the lower end of the recommended range is appropriate. The Hearing Panel agrees with Enforcement that no suspension is appropriate for this violation.

VI. Conclusion

Respondents Berry-Shino Securities, Inc. and R. Matthew Shino: (1) charged unfair and excessive commissions on retail agency transactions in listed options, in violation of Rule 2110; and (2) executed options transactions without having obtained required information and documentation from the customers, in violation of Rules 2860 and 2110. The charge that respondents failed to return investor funds when an offering failed to satisfy its minimum sales contingency, in violation of Section 10(b) of the Securities Exchange Act, SEC Rule 10b-9 and NASD Rule 2110, is dismissed.

For charging excessive commissions, respondents are fined $50,000, jointly and severally, and Shino is suspended in all principal capacities for 10 business days. For failing to obtain required information and documentation, respondents are fined $2,500, jointly and severally. In addition, respondents are ordered to pay costs in the amount of $2,963.76, which includes an administrative fee of $750 and hearing transcript costs of $2,213.76.

These sanctions shall become effective on a date set by NASD, but not earlier than 30 days after this decision becomes NASD's final disciplinary action in this matter, except that if this decision becomes NASD's final disciplinary action, Shino's suspension shall commence with the opening of trading on February 2, 2004 and shall end at the close of trading on February 13, 2004. The Hearing Panel urges that respondents be permitted to pay the monetary sanctions through an installment payment plan. Sanction Guidelines at 14.[27]

HEARING PANEL

By: David M. FitzGerald
Hearing Officer

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[27] The Hearing Panel has considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.