

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	Disciplinary Proceeding
	:	No. C3A010036
v.	:	
	:	
CASTLE SECURITIES CORP.	:	
(BD #16077)	:	Hearing Officer – DMF
	:	
Freeport, NY	:	
	:	
MICHAEL STUDER	:	HEARING PANEL DECISION
(CRD #707394)	:	
	:	
Rockville Centre, NY	:	March 28, 2003
	:	
RESPONDENT 3	:	
	:	
	:	
	:	
	:	
Respondents.	:	

Respondent Castle Securities Corp. violated Section 10(b) of the Securities Exchange Act, SEC Rule 10b-5, and NASD Rules 2510, 2120, and 2110 by churning the account of a customer. For that violation, Castle is fined \$88,300, representing a base fine of \$37,500 plus the firm’s profits of \$50,800 on commissions generated by the churning. In addition, respondents Castle and Studer violated Rule 3010 and 2110 by failing reasonably to supervise the trading in the customer’s account. For that violation, Castle and Studer are jointly and severally fined \$37,500, and Studer is suspended for 90 days in all capacities and ordered to re-qualify as a principal. The charges against respondent 3 and the charge that Castle violated Rule 2110 by inducing a customer to guarantee the margin accounts of other customers are dismissed.

Appearances

Roger Hogoboom, Esq., Bruce A. Spiegler, Esq., and Rory C. Flynn, Esq., for

Complainant.

Robert C. Beers, Esq., and Stephen W. Wilk, Esq., for respondents Castle Securities Corp. and Michael Studer.

Respondent 3, pro se.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on September 4, 2001, against Castle Securities Corp., a member of NASD; Michael Studer, Castle's president; John Fisher, a Castle registered representative; Respondent 3, a former Castle registered representative; and Respondent 4, Castle's compliance officer. The Complaint charged that (1) Castle, Fisher and Respondent 3 "churned" the account of customer PS, in violation of Section 10(b) of the Securities Exchange Act, SEC Rule 10b-5, and NASD Rules 2510, 2120, and 2110; (2) Castle, Studer and Respondent 4 failed reasonably to supervise the trading in PS's account, in violation of NASD Rules 3010 and 2110; and (3) Castle and Fisher improperly caused PS to guarantee the margin accounts of other Castle customers, in violation of NASD Rule 2110.

The respondents filed Answers denying the charges and requesting a hearing. Prior to the hearing, Fisher and Respondent 4 settled the charges.¹ The hearing as to Castle, Studer and Respondent 3 was held on December 16 and 17, 2002, in Melville, New York, before a hearing panel composed of the Hearing Officer, a former member of District Committee No. 10, and a former member of District Committee No. 3.²

¹ Fisher was suspended for thirty days, fined \$6,950, and required to pay restitution to the estate of customer PS in the amount of \$8,050. Respondent 4 was fined \$5,000.

² In this decision, the hearing transcript is referred to as "Tr."; Enforcement's exhibits as "C"; and respondents Castle and Studer's exhibits as "RC." Respondent 3 did not offer any separate exhibits.

II. Facts

A. Respondents and the AAP Program

Castle has been a member of NASD since 1985. It is a wholly owned subsidiary of Castle Holding Corp. Castle Holding is a publicly held company, of which Studer is an officer and a substantial, but minority, shareholder. Studer is registered as a general securities principal and a general securities representative and has been president of Castle since its inception. Respondent 3 was registered as a general securities principal and general securities representative with Castle until his registration terminated on September 24, 1999.³ (C-1. pp. 5-6; C-2, p. 5; C-4, pp. 5, 7; C-7, pp. 32-33; Tr. 52, 59-61, 66-67.)

In 1992, Castle's securities business was failing, and the firm suspended operations. Castle's clearing firm, J.B. Oxford & Company, suggested that the firm consider a day-trading operation. In response, Castle developed an Active Account Program ("AAP"), which was described as follows in Castle Holding's 1998 Form 10-K, filed with the SEC:

The Active Account Program ("AAP") is a division of Castle started in December 1992 to afford active customers quick executions using automated order entry systems (such as SOES, SelectNet and the ISLD ECN) at relatively low commission rates. Most AAP customers opened margin accounts and gave trading authorization to a Castle registered representative.

From December 22, 1992 to September 30, 1997, substantially all of Castle's revenues were derived from the AAP. During that time, the number of day trading customers at other firms using automated order entry systems increased steadily. The increased competition lowered AAP customer performance, which in turn resulted in departures of Castle AAP registered representatives and closings of Castle branch offices in

³ Although Respondent 3 is not currently registered, he remains subject to NASD jurisdiction for purposes of this proceeding, pursuant to Art. V, § 4 of NASD's By-Laws.

Glendale, California (in August 1997), Melville, New York (in September 1997) and Garden City, New York (in April 1998).

For the years ended September 30, 1997 and 1998, AAP customer transactions totaled 184,654 and 33,041, respectively. At September 30, 1999, the AAP has only one remaining registered representative day trading a discretionary account on a full time basis.

(C-7, pp. 4-5; Tr. 269-70.)

B. Trading in PS's AAP Account

PS opened an AAP account with Castle in February 1993. At the time, she was an eighty-six year old retired schoolteacher with a net worth, excluding her residence, of approximately \$700,000. She was generally a conservative investor, investing primarily in utility stocks, individual bonds and bond mutual funds. Fisher was PS's registered representative for a non-AAP account at Castle, in which she invested in bond mutual funds. In addition, "[s]ince the late '80's" he took "care of all her aspects of her life, medical, health and welfare, shopping, ... taking care of her bills, hiring aides," for which he was paid \$750 per month. PS had no relatives; Fisher "was totally responsible for her." Among other things, Fisher, an accountant, prepared PS's tax returns, for which he was paid an additional fee. Fisher testified that PS "became forgetful like most elderly people as time went on. ... Some days she was more on the ball than others." (C-21, pp. 26-30; Tr. 68-69, 148-52, 183-84.)

Fisher's prior experience as a registered representative was limited to mutual funds; he had no experience selling individual stocks or other types of investments to PS or any other customer. Nevertheless, after Studer described the AAP as "a safe

investment, fairly safe,” and “asked [Fisher] if [he] had customers that might want to go into it,” Fisher recommended it to PS. (Tr. 145-48.)⁴

PS signed the new account forms to open her AAP account, including a form stating: “I hereby give Castle Securities Corporation Full Discretion and authorization to buy, sell and trade securities in my account, which may be a margin account. Please also be advised that I understand the account will be extremely active on a daily basis and I understand the inherent risks therein.” After the account was opened, PS initially received the confirmations and monthly statements. From June 1993 on, however, Castle sent the confirmations and account statements to Fisher, who did not provide them to PS. In September 1993, PS signed a general power of attorney giving Fisher full authority to manage her affairs, which remained in effect throughout the period in issue. Thus, as a practical matter, PS was completely dependent upon Fisher to protect her interests. Castle, however, paid Fisher a commission on every trade in PS’s account, even though he had no involvement in or responsibility for the trades. (C-8, C-9, C-18; Tr. 68-69, 71, 157, 185-86.)

PS’s AAP account was assigned to Respondent 3, along with the AAP accounts of several other Castle customers. Respondent 3 day-traded all of these accounts, employing a strategy in which he opened long or short positions, generally through SOES, and quickly closed them, generally through SelectNet. In theory, this strategy allowed the customers to earn profits on short-term swings in stock prices. By the end of

⁴ Enforcement did not, however, allege that the AAP was unsuitable for PS.

each trading day, the customers' AAP account positions were generally flat.⁵ (C-8, p. 5; Tr. 273-74, 294, 402-403, 410-412.)

Respondent 3 testified that he traded PS's account like all his other AAP accounts. In fact, he placed trades during the trading day as opportunities arose without necessarily having any particular AAP account in mind. At the end of the day, he allocated the resulting gains or losses among the accounts as he thought appropriate. He also determined at the end of each day how much commission to charge on the trades, within a broad range between Castle's minimum and maximum commission amounts, which varied over the period that PS's account was open. Respondent 3 did not "negotiate" these commission charges with the customers, but based them on his assessment of what was fair, taking into consideration the results of his trading that day, as well as the overall performance of his accounts. In practice, the average gross commissions that Respondent 3 charged PS were consistent with the average commissions he charged his other customers, as well as the commissions that other Castle AAP brokers charged, and ranged from a high of \$37.88 per trade during 1993 to a low of \$12.94 per trade in 1995. (Tr. 406-07, 411-12; RC-21.)

As suggested in the new account forms, PS's AAP account was very actively traded. During 1993, Castle made approximately 1,500 trades in PS's account from which she earned profits of approximately \$9,500. Castle charged approximately \$59,000 in gross commission on these trades. During 1994, Castle effected nearly 6,000 trades in PS's account resulting in trading losses of approximately \$8,600 for PS and

⁵ Initially, PS's AAP account was funded with \$20,000 cash, but later a high-yield bond mutual fund was substituted for the cash. Because the margin account was day-traded, with the positions generally flat at the end of the day, the fund supported the trading, generally (but not always) without any need to liquidate any of PS's investment in the fund. (Tr. 169, 275-76; C-24.)

commissions of nearly \$88,000 for Castle. During 1995, there were nearly 10,000 trades in PS's account, which resulted in trading losses of nearly \$13,000 for PS and commissions of about \$140,000 to Castle. (C-13, p. 1; C-14, p. 3; C-15, pp. 1-2.)

By December 1995, PS had incurred an overall loss as a result of Castle's AAP trading, resulting in a negative cash balance in her account of approximately \$17,000. By this time, her account was funded with a bond mutual fund, which, Studer testified, represented a material portion of PS's total assets. The value of the bond fund was substantially in excess of the negative cash balance in the account. Nevertheless, Fisher testified that the negative cash balance concerned him, so he approached Studer with a proposal that he and Castle contribute \$7,000 each to a "settlement" with PS; Studer readily agreed. (Tr. 158-59, 180-81, 318, 375.)

Castle and PS entered into an agreement as of December 1, 1995, stating that "a dispute has arisen with respect to the amount of commissions charged" to PS in her AAP account, and that, to settle the matter, Castle would pay \$14,000 to PS. No mention was made of Fisher's \$7,000 contribution, or of the negative cash balance in the account, or that the negative balance was attributable to losses from the AAP trading. PS signed the agreement, as did Studer, for Castle. Castle issued a check in the amount of \$14,000 to PS on December 29, 1995, which PS endorsed for deposit to her bank account. On the same date, utilizing his power of attorney, Fisher issued a check drawn on PS's bank account in the amount of \$17,462.92 to Castle to clear the negative cash balance in PS's AAP account. (C-11; C-24, p. 702; Tr. 158-59, 318.)

At Studer's direction, Respondent 3 had stopped trading PS's AAP account in November 1995. In February 1996, however, Studer authorized Respondent 3 to resume

trading the account. At the hearing, Studer testified that Fisher had instituted the halt, but could not remember who initiated the resumption; Fisher, however, seemed unaware that trading in the account had ever been interrupted. In any event, when trading resumed, neither Studer nor Fisher told Respondent 3 to change the manner in which he had been trading the account. (Tr. 159, 318-19, 371, 404.)

During the remainder of 1996, Respondent 3 made approximately 3,900 trades in PS's account, resulting in a net gain to her of approximately \$2,300 and commissions to Castle of approximately \$70,000. In 1997, Respondent 3 made approximately 3,700 trades in PS's account, which resulted in a gain of approximately \$2,600 for PS and commissions of \$86,000 for Castle. In 1998, there were about 3,700 trades in the account with a net loss of approximately \$1,300 for PS and commissions of about \$72,000 for Castle. Finally, in 1999, before trading in the account was halted, there were nearly 2,200 trades, resulting in a net gain for PS of approximately \$450 and commissions for Castle of more than \$51,000. (C-13, p. 1; C-14, p. 3.)

Overall, from 1993 through 1999, Castle made more than 30,000 trades in PS's account (effectively, 15,000 "round trips" opening and closing positions) leading to net losses of about \$8,000, not including the \$14,000 Castle paid to PS in December 1995. If that amount is included, PS had a net gain over the six-year period of about \$6,000.⁶ During the same period, Castle's total gross commissions were more than \$550,000, even giving Castle credit for the \$14,000 settlement. Respondent 3 earned more than \$70,000 in total commissions. Fisher's total commissions, not including the \$7,000 that he

⁶ PS also received more than \$75,000 in 2000 and 2001, after trading in her AAP account ceased, as her share of the Nasdaq Market Makers Litigation class action settlement. (RC-7; Tr. 319-22.) For reasons explained below, the Hearing Panel did not consider this amount relevant in determining whether PS's account was churned.

contributed to Castle's payment to PS, were more than \$30,000. (C-13, p. 1; C-14, p. 3; C-15, pp. 1-2.)

During this period, PS's account became a significant portion of Castle's overall AAP business. As indicated in Castle's 1998 10-K, after a promising start, the AAP business fell off sharply. In 1993, the trades in PS's account represented about 0.5% of more than 322,000 total trades in Castle's AAP accounts; in 1994, she accounted for about 1.5% of Castle's approximately 385,000 AAP trades; in 1995, her trades were about 2.5% of Castle's approximately 396,000 AAP trades; and in 1996, after the settlement and resumption of trading in the account, trades in PS's account were about 2% of Castle's approximately 202,000 AAP trades. PS's share of the AAP total increased substantially in subsequent years. In 1997, her trades were about 5.2% of Castle's total AAP trades, which fell to about 70,000; in 1998, they were roughly 14.3% of Castles' approximately 26,000 AAP trades; and in 1999, her trades (which ended in June) represented about 9% of Castle's approximately 24,000 AAP trades. (C-14, p. 3; RC-21, p. 2.)

NASD and SEC examined Castle during the period when PS's account was being actively traded, but raised no concerns until NASD conducted an examination in June 1999. During that examination, NASD staff reviewed the trading in all discretionary accounts at Castle. By that time, only PS's account and one other discretionary account were being traded actively.⁷ Noting PS's advanced age and the heavy day-trading in her account over several years, the examiners focused their attention on her account. They did not review Castle's AAP program as a whole, or review other AAP accounts that had

⁷ By this time, Castle had opened an online day trading operation that allowed customers to trade their accounts directly, rather than give a Castle representative discretionary authority to trade. (Tr. 290-91.)

been traded heavily in the earlier years of the program, but were no longer active in 1999. After the NASD examiners expressed concern, Castle ceased trading PS's account, as of the end of June 1999. (Tr. 47-50; C-24.)

C. The Margin Guarantees

In January and February 1996, PS signed agreements guaranteeing five other customers' margin accounts. Specifically, she agreed: "If and when a margin call and/or a deficit is generated in the guaranteed account, JB Oxford [Castle's clearing firm] has the authority without restriction to use the funds or securities in my account to carry the guaranteed account or to pay any deficit therein." These guarantees were used only once. In October 1996, J.B. Oxford transferred \$30,000 from PS's account to one of the accounts she had guaranteed to cover a margin call. The \$30,000 was re-paid to PS's account in November 1996. (C-12; C-24, pp. 818, 835; Tr. 75-76.)

Fisher testified that he asked PS to sign the agreements based on his understanding that there would be reciprocal agreements from the other customers guaranteeing PS's account, which would increase the buying power in her account. Studer testified that J.B. Oxford, Castle's clearing firm, required cross-guarantees among all the affected margin account customers in order to make any margin guarantee effective. (Tr. 161-62, 334; RC-13, RC-14.)

Studer acknowledged that the customers whose accounts PS guaranteed never executed cross-guarantees. For this reason, he said, the guarantees she signed never became effective and should not have been used. He said that J.B. Oxford's use of one of the guarantees in October 1996 was an error by that firm, and that when the error was

noted, the funds were returned to PS's account. (RC-15; Tr. 338-41.) Enforcement offered no conflicting evidence on these points.

III. Discussion

The charges considered by the Hearing Panel were (1) whether Castle and Respondent 3 "churned" PS's AAP account, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Rules 2120, 2510, and 2110; (2) whether Castle and Studer failed reasonably to supervise the trading in PS's account, in violation of NASD Rules 3010 and 2110; and (3) whether Castle violated Rule 2110 by inducing PS to execute the margin guarantees.

A. Churning

"Churning occurs when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions." Sandra K. Simpson, Exch. Act Rel. No. 45923, 2002 SEC LEXIS 1278, at *52 (May 14, 2002), quoting Olson v. E.F. Hutton & Co., 957 F.2d 622, 628 (8th Cir. 1992) (other citations omitted).

Churning has been found where: (1) trading in an account was excessive in light of the investment objectives; (2) the broker exercised control over the account; and (3) the broker acted with the intent to defraud or with reckless disregard for the interests of the client. Churning "in essence, involves a conflict of interest in which a broker or dealer seeks to maximize his or her remuneration in disregard of the interests of the customer." This motivation creates the element of scienter necessary for a violation of the antifraud provisions of the securities laws. Scienter, in turn, is what separates "churning" from "excessive trading."

Donald A. Roche, Exch. Act Rel. No. 38742, 1997 SEC LEXIS 1283, at *12-13 (June 17, 1997), quoting Loss & Seligman, Securities Regulation, at 3877 (1991) (other citations

omitted). Churning violates Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Rules 2120 and 2110.

Castle and Respondent 3 admittedly exercised discretion in trading PS's AAP account. The remaining questions are whether they traded the account excessively, and, if so, whether they acted with scienter.

There is no magic formula for determining whether a particular level of trading is excessive. Historically, NASD, the SEC and the courts have looked at turnover ratio, the use of "in and out" trading, and the overall pattern of trading activity in the account in determining whether it was excessive. See, e.g., District Bus. Cond. Comm. for Dist. No. 2 v. Glikzman, 1999 NASD Discip. LEXIS 12, at *25-26 (NAC Mar. 31, 1999), aff'd, 1999 SEC LEXIS 2685 (Dec. 20, 1999). Ultimately, however, "[t]he essential issue of fact is whether the volume of transactions, considered in light of the nature and objectives of the account, was so excessive as to indicate a purpose on the part of the broker to derive a profit for himself at the expense of his customer." Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983). "The excessive trading element [of a churning violation] is not established ... unless the frequency of the trades is unrelated to the customer's objectives." Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, 632 F. Supp. 471, 484 (D. Me. 1986).

In this case, PS opened her AAP account with the understanding that "the account will be extremely active on a daily basis." Indeed, it was through very active day-trading that Castle hoped to make a profit for PS. According to Studer, when PS opened her account in 1993, his experience with AAP customers was that "everybody made money

every day, every customer ... it was a lucrative thing for the customers.” (C-8, p. 4; Tr. 274, 276.) Enforcement offered no conflicting evidence on this point.

Pursuing the AAP strategy necessarily required higher account turnover, more in and out trading, and much more active trading than would have been appropriate in a traditional investment account. Therefore, the Panel found that it could not evaluate the trading in PS’s account by simply comparing it to turnover, in and out trading, and trading activity levels that have been held to reflect excessive trading in traditional accounts. Instead, the Panel sought to determine whether the trading in PS’s account was excessive considering the nature and objectives of the AAP.

Enforcement did not prove that PS’s account was traded more heavily than Castle’s other AAP accounts, or that she was charged higher commissions than Castle’s other AAP customers. On the contrary, the undisputed evidence was that Respondent 3 traded PS’s account the same way he traded his other AAP accounts; that, at least during the early years, PS’s trades represented a small portion of Castle’s overall AAP trading; and that the commissions PS was charged were in line with those charged to other AAP customers. Finally, Enforcement did not allege or attempt to prove that the AAP was unsuitable for PS; Enforcement charged only that her account was churned.

As a result, the Hearing Panel found that Enforcement failed to prove, by a preponderance of the evidence, that during the period from 1993, when PS opened her AAP account, through 1995, “the volume of transactions, considered in light of the nature and objectives of the account, was so excessive as to indicate a purpose on the part of [Castle] to derive a profit for [itself] at the expense of [its] customer.”

By the end of 1995, however, circumstances had changed. Whatever Studer's experience and expectations were when the account was opened, and whatever the AAP trading results may have been for Castle's other customers, by December 1995 it was clear that PS was not "making money every day" and that the AAP was not "lucrative" for her. In fact, she had suffered substantial losses in 1994 and again in 1995, resulting in a \$17,000 cash deficit in her AAP account.⁸

This did not go undetected. Fisher noted the negative balance in the account, and proposed that he and Castle pay a total of \$14,000 to PS to help clear the deficit, which Studer promptly agreed to do. They accomplished this, however, by presenting PS with a "settlement agreement" that did not disclose that it was prompted by trading losses in the account, but rather indicated that "a dispute has arisen with respect to the amount of commissions charged." Moreover, the agreement did not disclose Fisher's contribution to the payment, or that, using his power of attorney, he would apply the funds from the settlement to help clear a cash deficit in PS's account attributable to the AAP trading. PS signed the agreement and endorsed Castle's check for deposit to her bank account; whereupon Fisher, using his power of attorney, drew a check on that account to clear the cash deficit and deposited it to PS's Castle account.

Then, in February 1996, Studer instructed Respondent 3 to resume trading PS's account, without disclosing the settlement or instructing him to trade any differently. As Castle Holding's 1998 10-K disclosed, through September 1997 "substantially all of Castle's revenues were derived from the AAP," yet the 10-K also acknowledged that Castle's AAP trading peaked in 1995 and diminished steadily beginning in 1996, as

⁸ Studer testified that AAP trading was affected by a number of regulatory changes during this period, so it should have been obvious to him that he needed to reexamine his 1993 assumptions about the benefits of the AAP for Castle's customers. (Tr. 283-87.)

customers left the program. As a result, the trading in PS's account from 1996 on became more and more significant for Castle's revenues, as it accounted for larger and larger portions of Castle's overall AAP volume.

The Hearing Panel concluded from these facts that when Castle, through Studer, resumed trading in PS's account in February 1996, it was primarily for the purpose of generating commissions, without regard to PS's interests. The Hearing Panel found that, under these circumstances, the trading was excessive, and Castle was at least reckless in undertaking it. Therefore, the Panel determined that, from February 1996 through June 1999, Castle churned PS's account.⁹

In making these determinations, the Hearing Panel considered and rejected a number of arguments raised by Castle. For example, Castle argued that it was entitled to rely on Fisher to represent PS's interests and monitor trading in the account, because she had given him a power of attorney. While that might have been a powerful argument if Fisher had been independent of Castle, he was not. He was associated with Castle, and Castle was paying him a commission for every trade in PS's account, even though he had no involvement in the trading decisions; Fisher earned this money simply by allowing Castle to continue to trade PS's account. In light of Fisher's own interest in continuing the trading, Castle could not reasonably rely upon him to represent the interests of PS.

Castle also argued that the amount of gross commissions it charged on the trades in PS's account significantly overstated the benefits to the firm, because Castle used much of the commission money to pay clearing firm fees and various other costs. But

⁹ Recklessness has been held sufficient to satisfy the scienter requirement under Section 10(b), Rule 10b-5 and Rule 2120. See, e.g., Department of Enforcement v. Fiero, 2002 NASD Discip. LEXIS 16, at *62 (NAC Oct. 28, 2002). Further, the SEC has held that "[t]he scienter element of churning may be inferred from the amount of commissions charged" David A. Wong, Exch. Act Rel. No. 45426, 2002 SEC LEXIS 339, at *14 (Feb. 8, 2002).

gross revenues are important to any firm, and as Castle Holding acknowledged in its 1998 10-K, the AAP made a substantial contribution to Castle's gross revenues. And as AAP customers began to leave the firm and Castle's overall AAP volumes decreased, the trading in PS's account contributed a greater and greater portion of Castle's AAP revenues. It also contributed significant profits, according to Castle's own analysis. Indeed, although Castle's profits from PS's trades amounted to only \$6,500 during the period 1993 through 1995, they increased to about \$50,800 during the period 1996 through 1999, when the Panel found the account was churned. (Tr. 293-317; RC-1.)

In addition, Castle argued that the AAP trading was in PS's interest because she used a bond mutual fund, rather than cash, to provide the capital needed to allow Castle to day-trade the account. In Studer's view, because she obtained the returns she earned on the funds invested in the mutual fund, "[w]hatever [additional money] she made [from the AAP trading] was gravy." (Tr. 276.)

In part, this argument rests on Studer's mistaken contention that, because the positions in her account were opened and closed very quickly, the AAP trading presented very little risk to PS. Actually, PS was at substantial risk every time Castle opened a position in her account, and Castle opened and then closed approximately 6,500 positions in PS's account from 1996 through 1999. Many of those positions were in excess of \$50,000, and while they were open PS faced market risk, including the risk that, for example, a news release, trading halt or other unexpected development could cause substantial losses before Castle could close the position. And, in fact, she did suffer substantial losses in 1994 and 1995, and after trading resumed in 1996, she had only very modest gains in 1996, 1997 and 1999, and losses in 1998. The only "gravy" from the

trading in her account went to Castle, not PS. As a practical matter, she was providing risk capital to support Castle's day-trading without receiving a corresponding return. As a result, at least by 1996 it should have been clear that continuing the AAP trading served only Castle's interests, not PS's.

Castle also argued that in assessing the benefits to PS from the trading in her AAP account, the Hearing Panel should include more than \$75,000 that PS's estate received in 2000 and 2001 as her share of the settlement of the Nasdaq Market Makers Litigation class action. (RC-7; Tr. 319-22.) This payment, however, was in the nature of a windfall. Neither Castle nor PS could have expected it during the period when her AAP account was traded, and therefore it is irrelevant in determining whether, in trading the account, Castle was pursuing its own interests at PS's expense.

Finally, Castle argued that it relied on the failure of SEC and NASD examiners, prior to 1999, to raise any objections to the AAP program generally, and, specifically, to the trading in PS's account. (Tr. 290-92, 328-29.) None of the examiners, however, blessed the AAP or the trading in PS's account; they simply failed to identify it as a potential violation. In reporting the results of its examination, the SEC specifically advised Castle that "the fact that this letter does not comment on other aspects of [Castle's] activities should not be construed to mean that such activities comply with the federal securities laws." (RC-12.) In addition, the SEC has emphasized that "a securities dealer cannot shift its compliance responsibility to the NASD. A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation." W.N. Whelen & Co., 50 S.E.C. 282, 284 (1990); see also Thomas C. Kocherhans, 52 S.E.C. 528, 531 (Dec. 6, 1995) ("[w]e have repeatedly held that a

respondent cannot shift his or her responsibility for compliance with applicable requirements to . . . the NASD.”).

Although the Hearing Panel found that Castle churned PS’s account, the Panel determined that Respondent 3 did not. Respondent 3 simply traded PS’s account in accordance with the AAP and his instructions for the account. Although Castle was chargeable with Studer’s and Fisher’s knowledge of the circumstances surrounding the settlement with PS in December 1995, Respondent 3 had no involvement in the settlement and was unaware of it. He also did not know why Studer told him to stop trading the account, or why Studer told him to resume trading in February 1996.

Respondent 3 earned more than \$70,000 in commissions trading the account, but that was over a period of more than six years. As he pointed out during the hearing, his commissions amounted to less than \$7 per hour for the time he spent trading PS’s account. Respondent 3 was trained as a day-trader, and never acted as a retail broker. He traded his accounts in accordance with the AAP, and had no direct contact with any of the customers. With regard to PS, he saw his responsibilities as limited to trading because of the active involvement of Studer and Fisher.

Respondent 3 testified, “always what I [had] in mind . . . at the end of the day [was to] try to make a profit [for my customers]... I never thought of executing transactions only for the purpose of generating commissions.” Having had an opportunity to observe and question Respondent 3, the Hearing Panel found this testimony credible, based on his demeanor and the supporting evidence. (Tr. 38-39, 404, 408.)

Accordingly, the Hearing Panel determined that Castle (but not Respondent 3) churned PS's account during the period February 1996 through June 1999, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Rules 2120 and 2110.¹⁰

B. Supervision

Enforcement also charged that Studer and Castle violated Rule 3010 by failing reasonably to supervise the activities in PS's account. Rule 3010 requires that NASD members "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]. Final responsibility for proper supervision shall rest with the member." Studer was Castle's president. The SEC has explained,

We have long maintained ... that "the president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient."

William H. Gerhauser, Sr., 53 S.E.C. 933, 940-41 (Nov. 4, 1998). Studer acknowledged that, at the relevant times, he had supervisory responsibility for Respondent 3's trading of PS's account. (Tr. 369-70; C-18, p.2.)

Whether supervision was reasonable "is determined based on the particular circumstances of each case. The burden is on [Enforcement] to show that the respondent's procedures and conduct were not reasonable. It is not enough to

¹⁰ The Panel found that Castle also violated Rule 2510(a), which provides: "No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account." Unlike churning, scienter is not required to establish a violation of Rule 2510(a). See District Bus. Cond. Comm. for Dist. 10 v. Pinchas, 1998 NASD Discip. LEXIS 59, at *15-16 (June 12, 1998).

demonstrate that an individual is less than a model supervisor or that the supervision could have been better.” District Bus. Cond. Comm. for Dist. No. 7 v. Lobb, 2000 NASD Discip. LEXIS 11, at *16 (NAC Apr. 6, 2000) (citations omitted).

In this case, only Studer had all the relevant information needed to evaluate whether the trading in PS’s AAP account was serving her interests, or only Castle’s. As of the end of 1995, he knew that PS was elderly and of limited means; that she had incurred substantial losses as a result of the trading to that point; that account statements and confirmations were going to Fisher, not to her; and that Fisher, although he held a power of attorney on her behalf, had a serious conflict of interest because Castle was paying him a commission for every trade in her account. He knew about the settlement agreement, including its failure to disclose the trading losses and resulting negative cash balance in PS’s account, or Fisher’s contribution to the settlement; and he knew that Fisher used his power of attorney to replenish PS’s AAP account from the settlement funds. He directed that trading in her account be halted, and that it be resumed; he knew the amount of commissions that Castle was earning from the trading and the importance of those commissions to the firm.

The Panel found that under these circumstances, Studer had a supervisory responsibility to take steps reasonably designed to prevent the churning of PS’s account, and that he failed to fulfill that responsibility. Instead, from February 1996 until June 1999, when NASD examiners questioned the trading, he allowed PS’s account to be traded for Castle’s benefit, in disregard of her interests. The Hearing Panel, therefore, found that Studer, and Castle through Studer, failed reasonably to supervise the trading in PS’s account, in violation of Rules 3010 and 2110.

C. Margin Guarantees

Enforcement contended that by obtaining margin guarantees from PS, Castle violated Rule 2110's general requirement that member firms "observe high standards of commercial honor and just and equitable principles of trade." Enforcement argued that Castle violated this standard because PS signed margin guarantees under which she incurred substantial risks, without any countervailing benefits.¹¹

According to Studer's uncontroverted testimony and supporting exhibits, J.B. Oxford required cross-guarantees from the other customers in order for the agreements PS signed to become effective. If the other customers had signed cross-guarantees, PS would have received some benefit; because they did not, the guarantees should not have been utilized. Studer testified that J.B. Oxford's apparent reliance on one of the guarantees in October 1996, which resulted in the transfer of \$30,000 from PS's account to the account of another customer, was an error by J.B. Oxford that was corrected when it was discovered in November 1996. There was no evidence to contradict Studer's testimony in that regard. (RC-14; RC-15; Tr. 334, 338-39, 341.)

The Hearing Panel therefore found that Enforcement failed to prove this charge by a preponderance of the evidence. It will be dismissed.

IV. Sanctions

A. Churning

The Sanction Guidelines for "Churning or Excessive Trading" recommend a fine of \$5,000 to \$75,000, plus the amount of any financial gain the respondent earned from its misconduct. NASD Sanction Guidelines at 86 (2001 ed.). In addition, they recommend a suspension in any or all capacities for ten business days to one year, and in

¹¹ Enforcement did not cite any prior NASD cases applying Rule 2110 to analogous circumstances.

egregious cases a longer suspension of up to two years or a bar. Id. The language of the Guidelines suggests that they were drafted with individual respondents, not firms, in mind, but in this case the Panel found only Castle responsible for churning PS's account. Enforcement, relying particularly on Castle's prior disciplinary history as an aggravating factor, requested that the Hearing Panel expel Castle from membership in NASD and fine it the maximum recommended under the Guidelines, \$75,000, plus the gross amount of its commissions during the entire PS's account was traded, which was approximately \$570,000.

The Guidelines list no specific factors for adjudicators to consider when setting sanctions for churning or excessive trading, but several of the general considerations applicable to all violations are relevant here, including the respondent's disciplinary history. Id. at 9-10. The Guidelines indicate that a "relevant" disciplinary history, which "may include (a) past misconduct similar to that at issue; or (b) past misconduct that, while unrelated to the misconduct at issue, evidences prior disregard for regulatory requirements, investor protection, or commercial integrity," is an aggravating factor that an adjudicator should consider in imposing sanctions. Id. at 3. In this case, although Castle has a fairly extensive history, none of its prior violations involved churning or excessive trading, and, considering the nature of the violations and the sanctions imposed, the Panel did not find that Castle's history established a disregard for regulatory requirements, investor protection or commercial integrity.¹² Therefore, although the Panel considered Castle's disciplinary history somewhat aggravating in setting sanctions

¹² Castle's disciplinary history includes: (1) an NASD Acceptance, Waiver and Consent ("AWC") in 1990 for failing to report NASDAQ volume (\$250 fine); (2) an NASD settlement in 1990 for failing to obtain written NASD approval before changing its clearing method, failing to establish a special reserve account and failing to calculate and deposit the amount required for that account (\$2,000 fine); (3) a 1991 order

for the churning violation, the Panel did not believe it justified the extreme sanctions that Enforcement sought.

The Panel also found that Castle's failure to acknowledge and address the excessive trading in PS's account over a period of years, until NASD examiners expressed concern, was an aggravating factor. Further, the excessive trading involved a customer who was particularly vulnerable, not only because of her age, but because her account was under the control of Fisher, who had a serious conflict of interest, which the Panel also found to be an aggravating factor.

On the other hand, the Panel also took into consideration that the violation related to trading in just one customer account in the AAP program, noting in that regard that Enforcement did not allege or attempt to prove a pattern of churning or excessive trading. In addition, although she was placed at risk, PS did not suffer substantial losses from the churning of her account; in fact, she earned approximately \$4,000 in trading profits during the period 1996 through 1999, when the Panel found her account was traded excessively. Finally, the Panel noted that Enforcement did not allege that the AAP was unsuitable for PS.

Taking all these circumstances into account, the Panel concluded that the sanctions that Enforcement requested were not appropriate to accomplish NASD's remedial goals. Instead, considering the various factors set forth above, the Panel

from the state of Georgia for selling unregistered securities through unlicensed salesmen (\$25,000 fine); (4) an NASD settlement in 1993 for failing to comply with a restrictive agreement and failing to notify NASD prior to opening two branch offices (\$1,000 fine); (5) an NASD settlement in 1993 for accepting payment to become a market maker in a non-NASDAQ stock and failing to maintain certain records relating to trading in the stock (\$4,000 fine); (6) an AWC in 1994 for failing to comply with the penny stock rule, distributing misleading sales literature and failing to adequately supervise (\$2,500 fine); (7) a National Business Conduct Committee decision in 1994, later affirmed by the SEC, for market manipulation, excessive and fraudulent mark-ups and failure to establish adequate supervisory procedures (\$25,000 fine and ordered to pay \$13,686.05 in restitution); and (8) an AWC in 1996 for violating the ACT rules for identifying short sales (\$500 fine). (C-6.)

determined that the appropriate sanction for this violation is a fine of \$88,300, which includes a base fine of \$37,500 (the middle of the range suggested in the Guidelines) plus \$50,800, representing the firm's profits on commissions generated by PS's account during the period 1996 through 1999 based on Castle's own profit analysis (RC-1.)¹³

B. Supervision

The Guidelines for "Failure to Supervise" recommend a fine of \$5,000 to \$50,000, plus the amount of any financial gain. In addition, they recommend a suspension of the responsible individual in all supervisory capacities for up to 30 business days, and in egregious cases, a longer suspension of up to two years in any or all capacities, or a bar. The "Failure to Supervise" Guidelines list specific considerations in setting sanctions for those violations, including whether the respondent "ignored 'red flag' warnings that should have resulted in additional supervisory scrutiny," and "the nature, extent, size and character of the underlying misconduct." NASD Sanction Guidelines at 108. Enforcement requested that for this violation Castle be expelled and Studer barred, and that they be fined the \$50,000 maximum recommended in the Guidelines.

As to this violation, both Studer and Castle have a clearly relevant disciplinary history. In 1994, the National Business Conduct Committee found that they had failed to establish, implement, and enforce reasonable supervisory procedures. Studer and Castle were fined \$25,000 and required to pay more than \$13,000 in restitution, jointly and severally, and Studer was suspended in all capacities for 30 days and required to re-

¹³ Although not bearing directly on the appropriate sanctions for Castle, the Hearing Panel notes that the sanctions requested by Enforcement against Castle are vastly greater than those imposed in the settlements with Fisher and Respondent 4. Fisher, in particular, bore substantial responsibility for the churning of PS's account.

qualify as a principal. Market Surveillance Comm. v. Castle Securities Corp., 1996 NASD Discip. LEXIS 37 (NBCC Oct. 21, 1996), aff'd, 1998 SEC LEXIS 24 (SEC Jan. 7, 1998). The Guidelines explain that NASD's policy is to impose "progressively escalating sanctions on recidivists." NASD Sanction Guidelines at 3.

In addition, the 1995 settlement raised a variety of red flags, discussed above, as did Fisher's conflict of interest. If Studer had exercised reasonable oversight and supervision, he would have realized at least by the end of 1995 that further trading in PS's AAP account would be for the benefit of Castle, not PS. His failure to heed these red flags was an aggravating factor. On the other hand, as discussed above, the violation involved a single customer's account, and she did not suffer any losses from the excessive trading.

Taking these factors into account, the Panel determined that the sanctions requested by Enforcement were excessive, but that substantial sanctions were required. Therefore, for this violation, Castle and Studer will be fined \$37,500, jointly and severally, and Studer will be suspended in all capacities for 90 days and required to re-qualify as a principal before serving again in that capacity.

V. Conclusion

Respondent Castle Securities Corp. violated Section 10(b) of the Securities Exchange Act, SEC Rule 10b-5, and NASD Rules 2510, 2120, and 2110 by churning the account of a customer, and respondents Castle and Michael Studer violated NASD Rules 3010 and 2110 by failing reasonably to supervise trading in the account. The charges against respondent 3 are dismissed, as is the charge that Castle violated Rule 2110 by inducing a customer to guarantee the margin accounts of other Castle customers.

For the churning violation, Castle is fined \$88,300, which includes a \$37,500 base fine plus \$50,800, representing the firm's profits from commissions generated by the churning. For the failure to supervise violation, Studer and Castle are fined \$37,500, jointly and severally, and Studer is suspended from associating with any NASD member in any capacity for 90 days and ordered to re-qualify as a general securities principal before serving again in that capacity. In addition, Castle and Studer, jointly and severally, shall pay costs in the amount of \$3,568.18, which includes an administrative fee of \$750 and hearing transcript costs of \$2,818.18.

These sanctions shall become effective on a date set by NASD, but not earlier than 30 days after this decision becomes the final disciplinary action of NASD, except that if this decision becomes the final disciplinary action of NASD, Studer's suspension shall begin on May 19, 2003 and end on August 17, 2003.¹⁴

HEARING PANEL

By: David M. FitzGerald
Hearing Officer

Copies to:

Castle Securities Corp. (via overnight and first class mail)
Michael Studer (via overnight and first class mail)
Respondent 3 (via overnight and first class mail)
Robert C. Beers, Esq. (via facsimile and first class mail)
Stephen W. Wilk, Esq. (via facsimile and first class mail)
Roger Hogoboom, Esq. (electronically and via first class mail)
Bruce A. Spiegler, Esq. (electronically and via first class mail)
Rory C. Flynn, Esq. (electronically and via first class mail)

¹⁴ The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent on in accord with the views expressed herein.