

NASD REGULATION, INC.  
OFFICE OF HEARING OFFICERS

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DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	Disciplinary Proceeding
	:	No. C01990013
v.	:	
	:	
	:	<b>HEARING PANEL DECISION</b>
	:	
	:	Hearing Officer - DMF
	:	
	:	August 2, 2000
Respondent.	:	

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*Digest*

The Department of Enforcement filed a Complaint against \_\_\_\_\_, \_\_\_\_\_ charging that he made unsuitable recommendations to a customer, in violation of NASD Conduct Rules 2310 and 2110, by recommending that the customer sell certain mutual funds and purchase others. Enforcement charged that \_\_\_\_\_ recommended and effected on behalf of the customer 11 such unsuitable mutual fund “switches” during the period May 1991 to July 1993. \_\_\_\_\_ filed an Answer denying the charge and requested a hearing.

Following the hearing, the Hearing Panel found that Enforcement failed to prove the charge. The Hearing Panel found that \_\_\_\_\_ offered a plausible explanation for each switch, explaining why it was suitable for the customer in light of specific facts and circumstances, and

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that Enforcement failed to offer credible evidence sufficient to rebut \_\_\_\_\_'s explanations.

Therefore, the Hearing Panel dismissed the Complaint.

*Appearances*

David A. Watson, Esq., Regional Counsel, San Francisco, CA (Rory C. Flynn, Esq., Chief of Litigation, Washington, DC, Of Counsel) for the Department of Enforcement.

\_\_\_\_\_, San Francisco, CA for  
Respondent.

**DECISION**

I. Procedural History

The Department of Enforcement filed a Complaint against \_\_\_\_\_, \_\_\_\_\_ on August 16, 1999, charging that he made unsuitable recommendations to a customer, in violation of NASD Conduct Rules 2310 and 2110, by recommending that the customer sell certain mutual funds and purchase others. Enforcement alleged that \_\_\_\_\_ recommended and effected on behalf of the customer 11 such unsuitable mutual fund "switches" during the period May 1991 to July 1993. \_\_\_\_\_ filed an Answer denying the charge and requested a hearing.

A hearing was held in San Francisco, California on April 5 and 6, 2000 before a Hearing Panel composed of a Hearing Officer and two current members of the District Committee for District 1.<sup>1</sup> Enforcement offered the testimony of five witnesses and offered

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<sup>1</sup> Following the hearing, but before preparation of this Decision, the Hearing Officer who presided at the hearing resigned from NASD Regulation, Inc. and a new Hearing Officer was appointed. The new Hearing Officer prepared this Decision for the Panel in accordance with Rule 9268(a), but, because he did not have an opportunity to observe the witnesses at the hearing, he elected not to participate in this Decision, which reflects the determinations of the two remaining Panelists who did observe the witnesses.

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exhibits CX 1-27, all of which were accepted in evidence. \_\_\_\_\_ offered the testimony of two witnesses, including himself, and exhibits RX 1-18, all of which were accepted in evidence.

## II. Facts

### A. Introduction

\_\_\_\_\_ has been in the securities industry since 1976. He is currently registered with an NASD member firm as a General Securities Representative. (CX 1; Tr. II, p. 59.) The charges in this proceeding concern \_\_\_\_\_'s actions while he was registered as a General Securities Representative with Smith Barney, Inc. and a predecessor firm, during the period May 1991 to July 1993. Specifically, the Complaint charges that \_\_\_\_\_ recommended and effected 11 unsuitable mutual fund “switches”<sup>2</sup> in the account held in the name of the LK living trust during the relevant period.<sup>3</sup>

Some of the relevant facts are quite clear. LK established the LK living trust in 1987. LK was the sole beneficiary of the trust during her lifetime. From the formation of the trust through the relevant period, LK and her son GK were the trustees, but the trust provided that LK retained all power over the administration of the trust during her lifetime unless a court found her incompetent and appointed a conservator, and there is no evidence that ever happened. (CX 3.) Shortly after she formed the trust, LK opened an account in the name of the trust with

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<sup>2</sup> The term “switch” may convey a variety of meanings in this context. In this Decision, the term is used to signify the sale of a mutual fund position in an investment account in order to purchase a corresponding position in another mutual fund. In this sense, a switch may be either suitable and appropriate for the customer or unsuitable and inappropriate, depending on the specific surrounding facts and circumstances.

<sup>3</sup> The NASD’s investigation began after Smith Barney filed an Amended Form U-5 with the NASD on August 28, 1996 disclosing that LK had filed a customer complaint with Smith Barney on August 19, 1996 alleging “unsuitability (mutual funds)” and claiming damages of \$300,000. (Tr. I, p. 32; CX 2.)

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\_\_\_\_\_ at Sutro, where he was then associated. (Tr. I, p. 207.) There are no allegations of any improper actions by \_\_\_\_\_ while the account was at Sutro.

In 1990, \_\_\_\_\_ moved to Shearson Lehman Brothers, which later merged into Smith Barney (for the sake of convenience, this Decision will simply refer to the firm as Smith Barney), taking the LK trust account with him. He remained at Smith Barney until July 1994, when he moved to Round Hill Securities, Inc. (Tr. I, pp. 207, 218.) \_\_\_\_\_'s supervisor at Smith Barney tried to persuade LK and GK to keep the trust account at Smith Barney, but they moved the account to Round Hill with \_\_\_\_\_. (Tr. I, p. 217.) In 1995, however, after LK retained a new investment advisor, she closed the Round Hill account and subsequently filed an arbitration claim, which has been settled. (Tr. I, p. 219; CX 13, p. 3.) There is no dispute that during the 1991 to 1993 period, \_\_\_\_\_ effected the transactions that are the subject of the Complaint.

The record is far less clear, however, as to other key facts, and several factors made it very difficult for the Panel to obtain a clear picture of the relevant events. First, those events occurred seven to nine years prior to the hearing. Not surprisingly, considering the passage of so much time, recollections appeared to differ substantially.<sup>4</sup> Second, as will appear from the discussion below, GK, as LK's son and co-trustee during the relevant period, could have offered critical testimony regarding disputed facts, but GK refused to testify at the hearing. Instead, he gave separate declarations to both parties that were inconsistent in various important

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<sup>4</sup> \_\_\_\_\_ asserted "laches" as an affirmative defense in his Answer, based on the length of time that elapsed between the alleged misconduct and the initiation of these proceedings, but did not attempt to develop or argue that defense at the hearing. For that reason, and in light of the Hearing Panel's dismissal of this proceeding on other grounds, the Panel finds it unnecessary to address that defense.

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respects, appeared to conflict with both \_\_\_\_\_'s and LK's testimony in certain respects, and also failed to address key factual issues. Third, there were material differences between \_\_\_\_\_'s description of relevant events in his testimony and LK's version as recounted in her testimony and her prior statements, and to a lesser degree between \_\_\_\_\_'s testimony and GK's declarations. But even though the Panel did not find \_\_\_\_\_'s testimony entirely convincing, it also found, for reasons described in detail below, that LK and GK were not credible or consistent witnesses, and that Enforcement failed to offer any other credible evidence that would have allowed the Panel to resolve disputed issues in Enforcement's favor.

**B. \_\_\_\_\_'s Testimony**

In his testimony, \_\_\_\_\_ indicated that during most of the relevant period, LK exercised close control over the investments in the trust account. He also testified, however, that GK was quite involved in management of the account, and exercised effective control during a period of time when LK was very ill. (Tr. II, pp. 72-74.) In fact, as discussed in detail below, \_\_\_\_\_ claimed that several of the switches were initiated by GK. (Tr. II, pp. 118-20.)

\_\_\_\_\_ testified that LK's primary investment objective was to increase her income, and that several of the mutual fund switches were initiated by GK or her to meet her objectives in that regard. (Tr. II, pp. 68, 71.) When GK or LK initiated a switch, \_\_\_\_\_ testified, he identified three or four alternative mutual funds that might satisfy their objective, after conducting due diligence including speaking to the fund managers. \_\_\_\_\_ discussed the alternatives with LK and GK, including the costs of the various alternatives, after which LK and GK selected the fund they wanted. (Tr. II, p. 72.)

C. The Switches

At issue were 11 switch transactions in the LK trust account at Smith Barney during the period May 1991 to July 1993. Prior to the hearing, the parties stipulated that the “sole claim by [Enforcement] is that [\_\_\_\_\_] engaged in the improper ‘switching of mutual funds’” and that “[Enforcement] does not contend, and there is no issue presented, that any of the individual trades [was] not suitable for the customer .... Therefore, [there] will be no issue in this proceeding regarding such suitability matters as the risk level of individual investments, the type of investment (individually or collectively, other than the fact that investments were in mutual funds), diversification (or concentration) of the portfolio or margin transactions (maintenance of a margin account or purchases on margin).” (Stipulation and Order filed Jan. 3, 2000.)

With regard to the overall pattern of switches, \_\_\_\_\_ testified that they were generally initiated as a result of objectives advanced by GK or LK. He testified that when this occurred, he recommended specific alternatives that would yield increased income to the trust, net of commissions, stating “that’s the only yield that counts.” \_\_\_\_\_ asserted that, on this basis, each of the switches he recommended was substantially advantageous to the trust. (Tr. II, 126-27, 129, 130-33.)

\_\_\_\_\_’s detailed explanations for the individual switches are as follows:<sup>5</sup>

1. In May 1991, \_\_\_\_\_ sold the trust’s positions in the Putnam California Tax Exempt Income Fund, in order to purchase a \$261,007.56 position in the Lord Abbett Bond

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<sup>5</sup> The parties exhibits summarizing the individual transactions reflect a few minor disagreements about specific dates, quantities, prices, total transaction amounts or commission amounts. Compare CX 26 with RX 2. The Hearing Panel’s findings reflect what appear to be the correct numbers based on sometimes conflicting underlying documents in the record. None of the differences was material, however, with regard to the Hearing Panel’s suitability determinations.

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Debenture Fund. The gross commission on this purchase was \$6,525.19, or approximately 2.5%. The trust had purchased the Putnam positions over an extended period of time. \_\_\_\_\_ explained this switch as follows: GK came to him seeking a bond fund with heavy growth potential; specifically, a fund that invested in convertible bonds. GK wanted the trust to invest in such a fund to get around LK's objection to investing in common stock. \_\_\_\_\_ first considered whether Putnam had such a fund into which the trust could move funds from the California Tax Exempt Income Fund without incurring commission charges. Putnam had a convertible stock fund, but that was not acceptable to LK because of her objections to holding stock; Putnam had no convertible bond fund. \_\_\_\_\_ identified the Lord Abbett fund, however, as satisfying GK's objectives without raising LK's concerns about owning stock. \_\_\_\_\_ was able to effect the purchase at a break point, for a 2.5% commission. (Tr. II , pp. 76-79; CX 26.)

2. In September 1991, \_\_\_\_\_ sold the trust's position in the Lord Abbett Bond Debenture Fund after just four months and purchased a \$268,807 position in the Putnam High Yield Trust. The gross commission on this purchase was \$6,048.18, or approximately 2.25%. \_\_\_\_\_ explained this transaction as follows: Even though the trust had held the Lord Abbett fund for only four months, GK asked him to sell in order to lock in the trust's profits in the Lord Abbett fund and because LK wanted to increase her income. The Putnam High Yield Trust was yielding greater income than the Lord Abbett fund, and Lord Abbett had no corresponding high yield fund. \_\_\_\_\_ discussed the costs of the transaction with GK and LK; there was a so-called "switch letter" that \_\_\_\_\_ sent to GK and LK explaining this, but \_\_\_\_\_ no longer

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has it. Even taking commissions into account, however, the trust had a \$7,800 gain on the Lord Abbett Bond Debenture Fund purchase. (Tr. II, pp. 79-82.)

3. In October 1991, \_\_\_\_\_ sold the trust's positions in Municipal Securities Trusts Nos. 11 and 132 and purchased a \$40,001.68 position in the Lord Abbett California Tax Free Income Fund. The gross commission on this sale was \$1,700.07, or approximately 4%. The trust had held the unit trusts since 1985 and 1989. \_\_\_\_\_ explained this transaction as follows: These were closed end municipal securities trusts in which there had been significant redemptions and decreasing yield. Under those circumstances, \_\_\_\_\_ felt it was prudent to recommend moving the funds into the Lord Abbett California Tax Free Income Fund to increase LK's income. (Tr. II. pp. 80-84; 133-34.)

4. In November 1991, \_\_\_\_\_ sold a portion of the trust's position in the Putnam High Income Government Trust and bought a \$57,987.92 position in the Putnam High Yield Trust. The trust had purchased the High Income fund position in May 1986. The gross commission on this purchase was \$1,304.73, or approximately 2.25%. \_\_\_\_\_ explained this transaction as follows: LK was seeking more income. The High Yield fund was generating more income than the High Income fund. Putnam should not have charged a commission on the transaction, because it was an exchange within the Putnam family. \_\_\_\_\_ simply missed the fact the commission was improperly charged. (Tr. II 84-88.) According to Smith Barney's records, this transaction was unsolicited. (CX 15, p. 22.)

5. In February 1992, \_\_\_\_\_ sold the balance of the trust's position in the Putnam High Income Government Trust, which the trust had held since 1986, and bought an additional \$55,770.78 position in the Lord Abbett California Tax Free Income Fund. The gross



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commission on this purchase was \$1,812.55, or approximately 3.3%. \_\_\_\_\_ explained this purchase as follows: This switch was initiated by GK, who wanted to increase LK's tax free income. In this case, Putnam had a California Tax Free fund, but after \_\_\_\_\_ did his due diligence and presented the results to GK, including explaining the commission costs involved, GK opted for the Lord Abbett fund because it had a significantly better earnings history than the Putnam fund. (Tr. II 88-89; RX 6.)

6. and 7. In April 1992, \_\_\_\_\_ sold the trust's position in the Putnam High Yield Trust and bought a \$335,007.30 position in the Provident Mutual Tax Free Bond Fund. The trust had purchased most of the Putnam position in September 1991, with additional purchases in November 1991 and March 1992. The trust paid a gross commission of \$13,400.29 on this purchase, or approximately 4%. In August 1992, \_\_\_\_\_ sold the trust's positions in the Lord Abbett California Tax Free Income Fund, which the trust had purchased between July and February 1992, and bought a \$130,007.20 position in the Provident Mutual Tax Free Bond Fund. The trust paid a gross commission of \$5,200.29 on this purchase, or approximately 4%. \_\_\_\_\_ explained these transactions as follows: Once again, GK initiated these switches. At the time, Smith Barney was predicting that interest rates would be rising. GK did not want to risk the trust's gains in the Putnam and Lord Abbett funds, because LK was having serious health problems and might need extra funds; he wanted to move money into a short-term bond fund. Lord Abbett and Putnam did not have such a fund available. \_\_\_\_\_ found the Provident fund, which had a five star rating from Morningstar. The trust realized a gain of \$19,000 on the sale of the Putnam fund, net of commissions. (Tr. II 89-95; RX 6-8.)

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8.- 11. In January 1993, \_\_\_\_\_ sold a portion of the trust's position in the Provident Mutual fund, which the trust had purchased beginning in April 1992, and purchased a \$180,000 position in the GT Investment Funds Global High Income Fund. Because \_\_\_\_\_ purchased the class "B" fund, the trust was not charged a commission at the time of this purchase. In April 1993, \_\_\_\_\_ sold an additional portion of the trust's position in the Provident Mutual fund and purchased an additional \$103,011.15 position in the GT Global High Income Fund. In June 1993, \_\_\_\_\_ sold the trust's position in the Sentinel Group Tax Free Fund, which the trust had held since 1990, and purchased an additional \$15,002.67 position in the GT Global fund. In July 1993, \_\_\_\_\_ sold the trust's remaining position in the Provident Mutual fund and purchased an additional \$200,012.56 position in the GT Global fund. All of these purchases were B funds, so the trust was not charged commissions at the time of the purchases.

\_\_\_\_\_ explained these purchases as follows: These were transactions that he recommended. Late in 1992 he became very enthusiastic about so-called "Brady Bonds," which were foreign-issued bonds guaranteed by the United States government. Because these bonds were relatively low-rated, the yield was much higher than U.S. government bonds, but the guarantee made them safe. His analysis was that as the countries that issued the bonds developed, the ratings would improve and the value of the bonds would increase dramatically. He identified the GT Global fund as having a substantial investment in Brady Bonds. (Tr. II, pp. 97-101.)

D. LK's Testimony and Other Statements

Enforcement offered LK's testimony at the hearing, as well as a declaration signed by LK that was prepared by NASD staff based on discussions with her. In addition, \_\_\_\_\_

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offered in evidence two sets of notes made by NASD staff after they interviewed LK in August 1998.

LK was 73 years old at the time of the hearing; she was in her mid-60's at the time of the switches. She testified that she had a high school education and two years of college before she married her husband in 1945. The account she opened with \_\_\_\_\_ at Sutro was her first securities account. (Tr. I, pp. 206-09.)

LK testified that her investment objective at all relevant times was income for herself, acknowledging that, for political reasons, she wanted no investments in companies involved in nuclear power or oil and gas. On the other hand, she indicated she had no particular objection to holding common stocks. (Tr. I, pp. 209-10, 221.) She testified that although her son GK was co-trustee, she made all the investment decisions. As a general matter, however, she said, she trusted \_\_\_\_\_, asked him to set up her investments safely and make her money, but otherwise gave him free rein. She said she does not know much about money, but \_\_\_\_\_ told her the various mutual funds he recommended were great, and she believed him. She claimed to have received a prospectus for only a few of the funds, but repeated that she had trusted \_\_\_\_\_. (Tr. I, pp. 210-14.) LK said she first became concerned after \_\_\_\_\_ recommended she borrow funds on margin from the account when she wanted to make a loan to GK to purchase a bookstore. She became unhappy about the margin interest, which increased over time. (Tr. I, pp. 211-12.)

LK's declaration is not detailed. It states that she was the primary contact on the account at all times and made all investment decisions, even when she was ill. According to the declaration, LK had few discussions with GK about the account. The declaration says that

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\_\_\_\_\_ made many investments in a discretionary manner, without written authority, and that LK often received confirmations for transactions that she had not authorized. The declaration states that LK became concerned about the account after she met a new investment advisor who told her she was too heavily invested in the GT Investment Funds Global High Income Fund and was paying too much margin interest. (CX 13.)

According to one set of notes of the meeting between NASD staff and LK, she stated, among other things, that she became convinced that \_\_\_\_\_ was “swindling” her through excessive commissions when, through a friend or acquaintance, she heard of an elderly woman who had supposedly “lost her whole fortune as a result of investing with \_\_\_\_\_.” She further stated that she learned of some transactions in the trust’s account only after receiving confirmations through the mail, and that after she read a newspaper article on churning, she spoke to \_\_\_\_\_ who told her he was “only doing it to make money.” (RX 14, pp. 1-2.)

In response to questions from NASD staff, LK first stated that she had never responded to various letters that Smith Barney sent to her asking whether she was satisfied with the manner in which \_\_\_\_\_ was handling her account. After being shown two responses to such letters bearing her purported signature, she admitted signing one, but claimed that the other was a forgery. Later she acknowledged that she had signed both letters. (RX 14, p. 2; RX 15, p. 5.)

These NASD staff notes include the following comments by the staff: “[LK’s] memory and recollection of the events leads one to believe that she had no real idea of what was going on until it was too late. However, it is unclear whether her lack of memory serves her own interest insofar as she stated that she never responded to any ‘happiness’ letters and then

changed her story once the letters were shown to her. ... A lot of what [LK] said hinges on what [GK] actually did or said. Based on her recollections, he appeared to act irresponsibly as her son and co-trustee of the trust account.” (RX 14, pp. 2-3.)

According to the other set of NASD staff notes from the same meeting, LK said \_\_\_\_\_ “began to juggle around figures and began to sell off small amounts of stock and that such activity went undetected by her and she didn’t worry.” She met a new investment advisor at about the same time she began hearing stories that \_\_\_\_\_ was involved in “shady dealings.” She claimed that “all of the investments had been done without her knowledge. Just done.” (RX 15, p. 2-3.)

According to this set of notes, LK said her new investment advisor told her she was too heavily invested in the GT Global High Income Fund and that she was paying too much margin interest. The new advisor introduced her to an attorney, who initiated an arbitration claim against Smith Barney that later was settled. She said she felt certain that \_\_\_\_\_ had churned her account in order to make money. Her main concern, however, was the margin on her account, and the amount of interest paid on the margin. (RX 15, pp. 3-4.)

LK acknowledged that between 1990 and 1994 she was ill with various types of cancer, including skin, kidney, liver and uterine cancer, but LK said in spite of all these serious ailments, she was always in complete control of the account and never become incapacitated. She had complete medical insurance coverage at all times, and did not need funds to pay medical costs. She also stated that her income in 1993 was about \$75,000, including funds she received from her husband’s testamentary trust, and that she does not spend all that income – in fact, she gives \$10,000 a year to each of her four children. She said she “never stipulated high

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income” as an investment objective. She also said her net worth was about \$1 million; at another point, however, she said that when her husband died in 1976 he left her \$1 million and another \$1 million went into his testamentary trust, of which she is the beneficiary. (RX 15, pp. 1, 4-5.)

LK’s testimony conflicts with \_\_\_\_\_’s in certain respects – in particular, she claims she was always fully in control of the account, even when she was ill, and that GK had little to do with managing the account – but neither her testimony nor her declaration directly addresses the circumstances of the individual switches that are at issue, and it appears from the interview notes in the record that the NASD staff never discussed the individual transactions during their 1998 interview with her. In addition, LK does not specifically contradict or even address \_\_\_\_\_’s claim that he carefully discussed the options with LK and GK in connection with each switch, including the associated costs. Finally, based on the Panel’s observations of LK during her testimony, it appeared that she sought to portray herself as naïve and uninformed about her account, but that she was in fact a strong and relatively sophisticated woman who was quite knowledgeable about her investments; for example, she sharply corrected Enforcement counsel when, during the course of her testimony, he understated the amount of commissions and margin interest she had paid during the relevant period. (Tr. I, pp. 21-27.)

#### E. GK’s Declarations

As explained above, GK refused to testify; instead, he gave declarations to both sides. The declaration that GK gave Enforcement is very terse. In it, GK states that LK was the primary contact on the account at all times; that LK made all investment decisions; that he had “few” discussions with LK or \_\_\_\_\_ about investments in the account; that the goal of the

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account was continuation of income for LK; and that he has very little investment experience.

(CX 12.)

In the declaration he gave to \_\_\_\_\_, on the other hand GK says that he received copies of the account statements and does not recall being concerned. As far as he knows, \_\_\_\_\_ discussed trades with LK and him before and after he effected them, and never made an unauthorized trade in the account. \_\_\_\_\_'s general practice was to call LK first, then to call GK, discuss the proposed transaction with him, and ask that he confer separately with LK. GK says this was because LK was hard of hearing, and \_\_\_\_\_ wanted to confirm her intentions, so there were no misunderstandings. (RX 1, pp. 1-3.)

In this declaration, GK says that he and LK had many conversations about her investments, often over dinner, but her investment objectives were never clear to him, and she would do what she wanted. LK was concerned about safety and "at times" expressed interest in increasing her income. She was opposed to investing in stocks and preferred investing in municipal bond funds. GK says that when LK hired a new investment advisor at the end of 1994 or early in 1995,

[h]er decision was prompted by concern with the Trust's margin account balance and the decline in value of the GT Global Income Fund. (The margin account had been established initially so that my mother could make a business loan to me.) During 1994, [\_\_\_\_\_] counseled against selling the GT Global Income Fund when its price declined ...; [\_\_\_\_\_] felt the investment would recover, which it did eventually. (I had bought the GT Global Income Fund for some of my family's accounts; I held half of my investment through the price decline in 1994-95 and later bought more shares when the price rebounded.)

GK also states, "After my mother terminated [\_\_\_\_\_] , she decided that he was a bad guy and has been very derogatory toward him subsequently. She may have been influenced by

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the new investment advisor's comments, which were critical of [\_\_\_\_\_].” He notes that \_\_\_\_\_ was his family's broker until 1999, when he moved all his family accounts in deference to LK's objections to \_\_\_\_\_. (RX 1, pp. 1-4.)

GK's declarations thus conflict with each other, concerning the level of communications he had with LK and \_\_\_\_\_ about the account, and with LK's testimony and declaration and the notes of her interview, concerning, for example, whether all of the transactions were authorized and discussed with LK. On the other hand, even the declaration that GK gave \_\_\_\_\_ does not confirm \_\_\_\_\_'s testimony that GK initiated several of the switches or that he was in effective control of the account when LK was ill.

F. \_\_\_\_\_ Testimony

\_\_\_\_\_, who was \_\_\_\_\_'s supervisor at Smith Barney, also testified at the hearing. \_\_\_\_\_ testified that he spoke to LK and GK by telephone and in person during the time the LK trust account was at Smith Barney, and he authenticated written communications with LK and his own notes of oral communications. (Tr. I, pp. 145-52; CX 6, 9.)

\_\_\_\_\_’s first contact with LK occurred in September 1992 when, acting in his capacity as branch manager, he sent her a form letter asking her to “reflect on her business” with Smith Barney in order “to be sure that you understand and are comfortable with the transactions in your account and that they meet with your investment objectives.” The letter included a questionnaire for LK to complete regarding these topics. When LK did not return the questionnaire, \_\_\_\_\_ called her to ask about the account. According to his testimony and contemporaneous notes of that conversation, he had a detailed conversation with her regarding the nature of her investments and the investment strategies that were being employed, confirmed



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that she believed the investments in her account were meeting her objectives, and confirmed that she was aware of the transaction costs and commissions generated in her account, including the savings available through break-point purchases of mutual funds. At the time he spoke to her, he thought she was fully aware of the nature of the investments in her account and felt the transactions met her investment objectives, and he believed she understood the transaction costs involved. (Tr. I, p. 145-49, 176-77; CX 6, pp. 1-2.)

\_\_\_\_\_ also identified a so-called “switch letter” which was intended to document LK’s approval of the June 1993 switch involving the sale of the trust’s position in the Sentinel Group fund in order to purchase an additional position in the GT Global High Income Fund. LK signed this letter, which indicated that the “transaction and the associated charges are entered into with my full knowledge and consent” based on her determination that her “investment needs will be better served by an investment in GT Global.” (CX 6, p. 3.) In November 1993, \_\_\_\_\_ sent LK another letter asking her to “reflect on [her] business” in order to “be sure that you understand and are comfortable with the transactions in your account and they meet with your investment objectives,” and enclosing a questionnaire. After LK failed to return the questionnaire, \_\_\_\_\_ sent a follow-up letter in March 1994. LK responded with a completed questionnaire dated March 7, 1994, in which she checked that she was aware of the nature of her investments and understood the strategies being employed, that she felt the investments being transacted in her account met her objectives, that she was aware of the margin balance in her account and felt that borrowing was suitable for her investment objectives, and that she was aware of the transaction costs, commissions and fees incurred as a result of the transactions in her account. She added a hand-written note stating that she and GK “are aware

of [\_\_\_\_\_]’s investments for me. I do wish that costs, commissions generated and fees amounts would more plainly be visible. They are high I know.” This March 1994 communication from LK occurred nearly eight months after the last of the 11 switches that are the subject of this proceeding. (Tr. I, pp. 149-52, 177; CX 6, pp. 4-6.)

\_\_\_\_\_ also testified that \_\_\_\_\_ left Smith Barney in 1994 after certain disagreements arose between them. Among other things, they disagreed about mutual fund switching, including some of the switches in the LK trust account. Even though \_\_\_\_\_ disagreed with \_\_\_\_\_, however, he believed \_\_\_\_\_ had a rationale for all of the switches. When \_\_\_\_\_ left Smith Barney, \_\_\_\_\_ attempted to persuade LK and GK to keep the account at Smith Barney. During July and August 1994, he had telephone conversations with LK during which she indicated she knew the account was on margin and wanted to reduce the margin in the account, but was concerned about losing income. She indicated she had agreed to invest in high yield funds. \_\_\_\_\_ also spoke to GK, who indicated he knew what was happening in the account and was willing to hold on for the long haul. After this conversation, he concluded that GK “seems to have a good understanding of his account.” (Tr. I, pp. 162-64, 173; CX 9.)

Finally, \_\_\_\_\_ met with LK and GK on August 31, 1994, in an effort to persuade them to keep the account at Smith Barney. He testified they “discussed ... the cost of mutual funds ... I showed them what happens on a switch, which, by the way, we had discussed, according to my notes, in 1992 ... we went over pretty much the total cost of the whole experience she had. So the mutual fund switches were the bulk of that. And, again, I would tell you the clients said they were very happy with [\_\_\_\_\_], that they were very comfortable with

it. I believe that, as I recall, they seemed to be more understanding of the nature of the commissions that were generated with the switches than the internal charges, but that was discussed. I was concerned. The client seemed to be ok with it.” His contemporary notes of the meeting confirm that “they were aware [of the costs] but not so clear on the internal [mutual fund] costs.” LK and GK told him that they felt \_\_\_\_\_ had done “a very, very good job, [and] that they felt that they understood the risks ....” (Tr. I, pp. 156-57, 166; CX 9, p. 1.) As noted above, after this meeting LK decided to move the account to \_\_\_\_\_’s new firm.

In general, \_\_\_\_\_’s testimony is consistent with \_\_\_\_\_’s. In his contemporaneous communications with LK and GK, they appeared to be aware of all the transactions in the account. In particular, when \_\_\_\_\_ reviewed the switches with them, they confirmed they were aware of the transactions and, apparently, of the relative costs of effecting them, and, not withstanding \_\_\_\_\_’s explanations in this regard, they elected to continue with \_\_\_\_\_.

#### G. Additional Relevant Facts

The total amount of funds in LK’s living trust and her overall financial status at the relevant time are not entirely clear from the record. Enforcement did not elicit any testimony from LK or offer any other testimony or documentary evidence to establish LK’s overall financial condition. \_\_\_\_\_, on the other hand, testified that he was well aware of her overall financial status and repeatedly suggested she had total assets of approximately \$5 million. On the other hand, the new account form he completed when the trust opened the account with Smith Barney in 1990 and another new account form completed in 1993, while not entirely legible, appear to indicate total assets of \$1 million, while the new account form \_\_\_\_\_ prepared when he and LK moved from Smith Barney to Round Hill in September 1994

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indicates her net worth was \$3 million. (Compare Tr. II, p. 66 (the money he was managing was 10% of her total wealth), Tr. II, p. 112 (\$5 million in trust assets), and Tr. II, pp. 139-40 (total trust assets of \$5 million), with CX 4 (Smith Barney new account forms which appear to indicate net worth of \$1 million), CX 10 (Round Hill new account form indicating \$3 million net worth). LK told NASD staff that when her husband died in 1976, “half of his assets (\$1 million) was put in [a testamentary] trust, the other half (\$1 million) went to his wife [LK],” but apparently did not discuss the value of those assets during the relevant period 1991-1994. (RX 15, p. 1.)

Transactions in the LK trust account (not limited to those at issue here) represented 5.9% of \_\_\_\_\_’s net commissions (\$7,074 of \$119,866) in 1991; 6.6% of his net commissions (\$9,170 of \$138,510) in 1992; and 7.2% of his net commissions (\$10,931 of \$151,442) in 1993. (CX 7, 8.) On the other hand, there is evidence in the record indicating a total gain in the account of \$155,000, exclusive of commission charges, during the approximately four years that the account was at Smith Barney, or an average of 11% per year. (Tr. II, pp. 40-48; RX 3.) The turnover rate in the account was approximately 1.2 – that is, the account turned over a little more than once each year – but nothing in the record addresses how this rate compares with similar accounts invested primarily in income generating mutual funds. (Tr. II, p. 56.)

With regard to LK’s supposed desire for greater income, the account statements in the record indicate total earnings in the account of approximately \$42,200 in 1991, of which approximately \$9,600 was non-taxable; approximately \$36,800 in 1992, of which approximately \$20,100 was non-taxable; approximately \$61,300 in 1993, of which approximately \$8,200 was non-taxable; and a total of approximately \$59,700 in 1994 at both

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Smith Barney and Round Hill, all of which was taxable. (CX 5, pp. 83, 151, 230, 298; CX 11, p. 6.) These are gross earnings in the account, however, not limited to earnings derived from the specific funds in issue; moreover, the record does not support any conclusions about what the account's earnings would have been if the switches had not occurred.

### III. Discussion

Rule 2310, the suitability rule, provides in relevant part:

- (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
- (b) Prior to the execution of a transaction recommended to a non-institutional customer, ... a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Mutual fund switching involves a specific application of these principles. As IM-2310-2 explains, "Trading in mutual fund shares, particularly on a short term basis, [may violate the suitability standards]. It is clear that normally these securities are not proper trading vehicles and such activity on its face may raise the question of Rule violation." Notice to Members 94-16 explained: "Members ... have an obligation to evaluate the net investment advantage of any recommended switch from one fund to another. Switching among certain fund types may be difficult to justify if the financial gain or investment objective to be achieved by the switch is undermined by the transaction fees associated with the switch."

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As Enforcement points out, these standards have been applied by the NASD in many cases, and their application has been approved by the SEC. Most of those cases, however, differed significantly from the instant case. Typically, they have involved large numbers of switches in numerous customer accounts with no colorable justification. Mutual fund switches are not per se unsuitable; rather, “what may appear to be an excessive turnover of mutual fund holdings may or may not be unsuitable.” District Business Conduct Committee for District No. 3 v. Investment Management & Research, Inc., Complaint No. C3B940028 (NBCC July 25, 1997). The NBCC went on to explain: “The fact that [the respondent] engaged in what appears to be excessive switching in these accounts does not necessarily make each switch per se unsuitable. Further, any particular holding period for mutual funds is not per se suitable or unsuitable for a particular customer.” Therefore, even though the respondent had recommended 147 mutual fund switches in 10 accounts, which “raise[d] the presumption that the switches alleged in the complaint were unsuitable for the customers, [the NBCC] reviewed each account on a transaction by transaction basis to determine the suitability of each switch alleged in the complaint.” If such a detailed analysis was required under those circumstances, it is even more clearly required in this case, which involves only 11 switches in the account of a single customer.

Unfortunately, it is very difficult to conduct such an evaluation based on the limited evidence in the record. As set forth above, \_\_\_\_\_ has offered at least a plausible explanation for each of the 11 switches. In general, he claims they were responsive to changes in the objectives and demands of the trustees. More specifically, \_\_\_\_\_ testified that the first switch involved the sale of a Putnam tax free income fund and purchase of a Lord Abbett fund that

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was heavily invested in convertible bonds in order to further the customer's growth objective.<sup>6</sup> Enforcement did not offer any credible evidence to contradict \_\_\_\_\_'s testimony. \_\_\_\_\_'s explanation for the second switch, which involved the sale of the Lord Abbett fund after just four months and purchase of a Putnam high yield fund, is more troubling, but again not entirely implausible. \_\_\_\_\_ claimed that the switch was initiated by GK, who wanted to lock in gains in the Lord Abbett fund and increase LK's income; that the Putnam high yield fund was yielding greater income than the Lord Abbett fund, even after taking commissions into consideration; and that Lord Abbett had no corresponding high yield fund. Enforcement offered no contrary evidence.

The third switch involved the sale of closed end funds that the trust had held for a number of years in order to purchase a tax free income fund. \_\_\_\_\_ testified that the yield on the closed end funds had become very low. Enforcement offered no contrary evidence. The fourth switch involved an intra-family move from a Putnam high income government fund to a Putnam high yield fund, for which no commission should have been charged. It is undisputed that, in fact, the trust was charged a commission on this transaction, but \_\_\_\_\_ is charged with effecting an unsuitable switch, not with failing to note and reverse the commission.

The fifth switch involved the sale of the balance of the trust's position in the Putnam high income government fund, which the trust had held for approximately six years, in order to purchase a Lord Abbett California tax free fund. \_\_\_\_\_ claims that this switch was initiated by

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<sup>6</sup> According to Smith Barney documents in the record, this switch was unsolicited. If that were true, the suitability rule would be inapplicable to this transaction. But although \_\_\_\_\_ testified that GK initiated this transaction by seeking a convertible bond fund, \_\_\_\_\_ implied that he recommended the specific fund that the trust purchased and did not argue that the transaction was unsolicited. Therefore, the Hearing Panel does not rest its assessment of the first switch on this point.

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GK in order to increase LK's tax free income, and that GK selected the Lord Abbett fund over a Putnam fund, for which there would have been no commission charge, based on the higher earnings history of the Lord Abbett fund. Enforcement offered no contrary evidence.

\_\_\_\_\_ claims that the sixth and seventh switches were initiated by GK, who wanted to reduce the risk to the trust in light of predicted increases in interest rates by purchasing a fund that held shorter-term bonds. Again, Enforcement offered no contrary evidence. \_\_\_\_\_ claims that the eighth through eleventh switches were based on a careful analysis that led him to recommend investment in a fund that was substantially invested in Brady Bonds. The Panel did not necessarily agree with \_\_\_\_\_'s analysis and is very troubled about the concentration of the trust's assets in this fund. But the parties stipulated that the charges against \_\_\_\_\_ rested exclusively on a theory of improper switching, not undue concentration, and Enforcement failed to offer any evidence to contradict \_\_\_\_\_'s testimony concerning the circumstances that led him to recommend the GT Global High Income Fund.

The Panel carefully questioned \_\_\_\_\_ about his rationale for these switches in an effort to determine whether he understood and had fulfilled his obligations in recommending them. In response, \_\_\_\_\_ testified that he evaluated the net investment advantage of each recommended switch from one fund to another, as required by NTM 94-16, and that each of the switches he recommended was advantageous to the trust. (Tr. II, 126-27, 129, 130-33.) It is true, as Enforcement pointed out, that \_\_\_\_\_ was not prepared at the hearing to lay out his detailed calculations supporting these claims, but that is not surprising given that seven to nine years had elapsed since the transactions occurred. For its part, Enforcement offered no



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contrary analysis of the transactions, showing that, in fact, the switches were not advantageous to the trust.

It is also true that \_\_\_\_\_'s description of the relationship among himself, GK and LK with regard to the management of the account is contrary to or unsupported by the evidence of LK and GK that is in the record, but the Hearing Panel did not find either LK or GK credible in this regard. Having had an opportunity to observe LK's testimony at the hearing, the Hearing Panel concludes that LK's current recollection of the relevant facts appears guided by her own perceived self-interest and her animosity toward \_\_\_\_\_. Furthermore, LK's testimony conflicted not only with \_\_\_\_\_'s testimony, but also with GK's statements regarding important facts in the declaration he gave to \_\_\_\_\_. The picture she sought to portray of a naïve, uninformed investor also conflicted with \_\_\_\_\_'s observations and communications, as recounted in his testimony and recorded in his contemporaneous notes.

Under these circumstances, GK's testimony was critically important. GK refused to testify for either side, however, but instead gave both parties declarations, which were admitted in evidence. Such declarations are hearsay – statements made outside the hearing offered to prove the truth of the matters asserted. It is well settled that hearsay is admissible in NASD proceedings, and in an appropriate case hearsay may form the sole basis for findings of fact. In re Charles D. Tom, 50 S.E.C. 1142, 1145 (1992). Before relying on such evidence, however, “it is necessary to evaluate its probative value and reliability, and the fairness of its use. The factors to consider include the possible bias of the declarant, the type of hearsay at issue, whether the statements are signed and sworn to rather than anonymous, oral or unsworn,

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whether the statements are contradicted by direct testimony, whether the declarant was available to testify, and whether the hearsay is corroborated.” Id.

These factors weigh heavily against according substantial weight to GK’s declarations. GK’s decision to give declarations to both sides, but to refuse to testify, by itself raises serious questions about the reliability of his statements, and the inconsistencies and omissions in those declarations increase the level of concern. In addition, GK’s possible bias is evident; he is GK’s son, as well as having been her co-trustee at the relevant time. Given GK’s acknowledgment of LK’s hostility toward \_\_\_\_\_, which was also apparent to the Panel during her testimony, it is reasonable to suspect that GK might well alter or color his testimony in order not to antagonize her by helping \_\_\_\_\_, or perhaps by confirming his role in the switches. On the other hand, his willingness to give a declaration to \_\_\_\_\_, albeit one that did not confirm all of \_\_\_\_\_’s story, suggests that GK does not believe, even now, that \_\_\_\_\_ recommended and effected unsuitable switches to benefit himself at the trust’s expense.

This is not to suggest that the Panel simply accepted \_\_\_\_\_’s version of the facts, or that the Panel was untroubled by the inconsistencies in the testimony and statements of the witnesses. The Panel noted, for example, that the tenor of the declaration that GK gave \_\_\_\_\_ suggested GK was more removed from active management of the trust’s account than \_\_\_\_\_ indicated in his testimony, and that, in particular, GK did not confirm that he initiated any of the switches or that he exercised effective control over the account while LK was ill. Nevertheless, under the circumstances, the Hearing Panel could not reject \_\_\_\_\_’s testimony based on the statements and omissions in GK’s declarations without the Panel having had an

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opportunity to observe GK, and without \_\_\_\_\_ having had an opportunity to question GK before the Panel.

The problems posed by LK and GK were not necessarily fatal to Enforcement's case. For example, Enforcement might have offered a detailed analysis of each switch showing that \_\_\_\_\_ could not reasonably have advised GK and LK that the switch was likely to result in any net investment advantage for the trust in light of the associated transaction fees. Such an analysis might have given the Panel a basis for rejecting \_\_\_\_\_'s testimony and concluding that, through the switches, he was seeking to enrich himself at the trust's expense. See In re Kenneth C. Krull, Exchange Act Release No. 40768, 1998 SEC LEXIS 2664, at \* 9-10 (Sept. 10, 1998) (the evidence "demonstrat[ed] that [the respondent's] chief concern was maximizing the amount of his commissions rather than serving the best interests of his customers"). Enforcement, however, offered no such analysis. Furthermore, Enforcement offered no evidence or analysis to rebut \_\_\_\_\_'s claim that he had properly analyzed and advised his clients of the net investment advantage of each switch, or to rebut \_\_\_\_\_'s evidence that during the relevant period the trust's account realized gains averaging 11% per year, far outstripping the amount of commissions the trust paid.

Instead of analyzing the suitability of each switch in detail, Enforcement rested its case on the contention that all of the switches were plainly unsuitable just because they involved moves from one bond fund to another bond fund. That is, Enforcement seemed to adopt the simplistic view that the investment objectives of all income funds are so similar that it would never be suitable to recommend, for example, a switch from a tax free bond fund to a convertible bond fund or a high yield fund, or from a fund invested in tax free obligations of one

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state to a broader tax free fund, or from a long-term bond fund to a short-term bond fund, or from a fund invested primarily in domestic bonds to one invested in international bonds. This is far too narrow a view of mutual fund investing in the modern day.

The Department of Enforcement had the burden of establishing, by a preponderance of credible evidence, that \_\_\_\_\_ committed the alleged violations. District Business Conduct Committee v. Lawrence P. Bruno, \_\_\_\_\_, No. C10970007 (NAC July 8, 1998). In In re Winston H. Kinderdink, 46 S.E.C. 636, 1976 SEC LEXIS 783, at \*9 (1976), the SEC explained:

[W]here, as here, a pattern of similar switching transactions in fund shares is established, it is incumbent upon the person responsible to demonstrate the unusual circumstances which justified such a clear departure from the manner in which investments in mutual funds are normally made. Kinderdink failed to introduce evidence showing that he had any reasonable grounds to believe that his recommendations to switch from one fund to another were suitable. Moreover, his explanations were not only implausible, but affirmatively demonstrated the lack of any reasonable basis for the pattern of mutual fund switching he induced in his customers' accounts. [Footnote omitted.]

Under this standard, Enforcement arguably satisfied its initial burden by showing the 11 switches in the LK trust account during a relatively short period of time, requiring \_\_\_\_\_ to come forward with a plausible explanation for each switch, showing he had reasonable grounds for believing it was suitable. In contrast to Kinderdink, the Hearing Panel finds that in this case \_\_\_\_\_ offered such an explanation. At that point, the burden shifted again, requiring Enforcement to offer credible evidence and analysis sufficient to rebut \_\_\_\_\_'s explanation. For the reasons set forth above, the Hearing Panel finds that Enforcement failed to satisfy this burden. Therefore, this proceeding will be dismissed.

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#### IV. Conclusion

The Hearing Panel finds that Enforcement failed to establish by a preponderance of credible evidence that Respondent \_\_\_\_\_, \_\_\_\_\_ violated Rules 2310 and 2110 by recommending and effecting unsuitable mutual fund switches in a customer account, as alleged. Therefore, this proceeding is dismissed.<sup>7</sup>

#### **HEARING PANEL**

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By: David M. FitzGerald  
Hearing Officer

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<sup>7</sup> The Hearing Panel 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.