NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C07000003
v.	:	
	:	**HEARING PANEL DECISION**
JACK H. STEIN (CRD #1233359), West Palm Beach, FL	:	Hearing Officer – JN
	:	March 6, 2001
Respondent.	:	

Digest

The Department of Enforcement filed a Complaint alleging that Respondent Jack H. Stein: (1) made unsuitable recommendations to a customer, in violation of NASD Conduct Rules 2110 and 2310; (2) conducted a securities business in the State of New York without being properly registered in that State, in violation of NASD Conduct Rule 2110; and (3) conducted a securities business without being properly registered with the NASD, in violation of NASD Conduct Rule 2110 and NASD Membership and Registration Rules 1031 and 1032.

The Hearing Panel found that Stein made unsuitable recommendations, but that Enforcement failed to prove the registration violations. As sanctions, the Panel imposed a fine of $25,000 and suspended Stein from association with any NASD member in any capacity for a period of one year.

Appearances

Gary M. Lisker, Esq., Senior Regional Counsel, Atlanta, GA (Rory C. Flynn, Esq., Chief Litigation Counsel, Washington, DC, of counsel), for the Department of Enforcement.

Neil S. Baritz, Esq., Boca Raton, FL, for the Respondent.

DECISION

I. Introduction

The Department of Enforcement filed its Complaint on January 21, 2000. The First Cause of the Complaint alleges that Stein made unsuitable recommendations to a customer, in violation of NASD Rules 2110 and 2310. The Second Cause alleges that Stein conducted a securities business in the State of New York without being properly registered in that State, in violation of NASD Rule 2110. The Third Cause alleges that Stein conducted a securities business without being properly registered with the NASD, in violation of NASD Rules 1031, 1032, and 2110. Respondent filed an Answer denying the charges.

Respondent initially requested a Hearing in this proceeding. However, he later waived that right, and the Parties elected to have the case heard on a paper record. This decision by a Hearing Panel, composed of an NASD Hearing Officer and two current members of the District 7 Committee, addresses the merits of this case, based on the parties' written submissions: Enforcement's Brief in Lieu of Hearing ("Brief") with eleven attached exhibits (CX-1-11); two supplemental exhibits (CX-12-13); Respondent's Response ("Response") with twelve attached exhibits (RX-A-L); and Enforcement's Reply Brief ("Reply Brief").

After considering the evidence presented in the Parties' submissions, the Hearing Panel finds that Respondent made unsuitable recommendations to a customer, but that

Enforcement failed to prove that Respondent conducted a securities business without being properly registered with the State of New York or the NASD. As sanctions for the suitability violation, the Hearing Panel fines Stein $25,000 and suspends him from association with any NASD member firm for a period of one year.

II. Discussion

A. Jurisdiction

Article V, Section 4 of the NASD By-Laws creates a two-year period of retained jurisdiction over formerly registered persons, covering conduct which began before the registration terminated. Stein was associated with Josephthal Lyon & Ross, Inc. from December 1991 through April 1996, with Greenway Capital Corp. from May 1996 through July 1996, and with Joseph Dillon & Company, Inc. from July 1996 through March of 1998. (Complaint, para. 1). Enforcement filed its Complaint on January 21, 2000, within two years of that date. All three causes of the Complaint allege conduct which occurred before the termination. The NASD thus has jurisdiction over this proceeding.

B. Unsuitable Recommendations

1. Facts

The First Cause of the Complaint alleges that Stein made several unsuitable recommendations to customer EA, a widow, who was a social worker in a New York City hospital, earning a salary of about $25,000 per year (Brief, p. 2). In March of 1994, when EA was 57 years old, she transferred her brokerage account from Merrill Lynch to Josephthal Lyon & Ross, Inc. ("Josephthal"), where Stein acted as her broker (Id.). EA's account, then worth approximately $78,000, included conservative investments, such as municipal bonds and preferred shares of Ford Motor Company (Id.).

EA's new account form at Josephthal listed her annual income as $25,000, her net worth as $100,000, and her investment objectives as "income" (Brief, pp. 2-3; CX-3). Stein later added "spec[ulation]" to EA's investment objectives, and when she followed him to two subsequent firms (Greenway Capital Corp. and Joseph Dillon & Company, Inc.), EA's account forms listed her investment objectives as growth and speculation (Brief, pp. 4, 6, 8; CX-7). Stein states that these changes were consistent with EA's changed investment goals; however, EA told the NASD that throughout her dealings with Stein, her investment goal was income (Response, p. 4; Brief, p. 12).

In May of 1994, Stein opened a margin account for EA (Brief, p. 3). EA denies that Stein ever explained the nature of such an account or the risks inherent in it (Id.). Stein emphasized the fact that EA signed the relevant account forms, and contends that he informed her of the risks of a margin account (CX-11; Response, pp. 4, 8).

Over the next three and one-half years with three different firms, Stein replaced most of EA's conservative investments with purchases of speculative oil, gas, and metal securities (Brief, pp. 4-9; CX-2). Stein admitted in his on-the-record interview that all of these investments in her accounts resulted from his recommendations (CX-11; Tr. 28-29, 49, 52, 62, 69, 80-83).

At the end of 1994, almost half of EA's portfolio was invested in speculative securities (Brief, pp. 3-4). At the end of 1995, approximately 60% of her holdings consisted of such speculative investments (Id., p. 5). During the first quarter of 1996, the percentage increased to 62%, with 59% of the portfolio consisting of shares of AGC Americas Gold Corp. ("AGC") (Id.). By July of 1996, 92% of EA's account was invested in AGC; by the end of January of 1997, 90% of her account was invested in speculative securities; and by

the end of November of 1997, 80% of her account was so invested (Id., pp. 6, 8-9). Moreover, the value of EA's account fluctuated throughout the duration of her relationship with Stein, until, ultimately, it reached a low of $38,345 at the end of November 1997, when EA terminated her dealings with Stein (Brief, pp. 3-9).

As shown, Stein admitted that he made the recommendations which culminated in EA's speculative oil, gas, and metal holdings, explaining that she came to him seeking information about speculative investments (CX-11; Response, p. 2). Stein further admitted that EA changed her investment objectives from income to growth and speculation following conversations with him (Id., p. 4). Stein further stated that EA authorized all of the transactions with full knowledge of their speculative nature and attendant risks (Id., pp. 3-4). He stated that he informed EA of the risks associated with investments in oil, gas, and metals, and told her that "she must be comfortable with a three to five year investment horizon" (Id., pp. 2-3). Lastly, Stein stated that EA told him that she had prior brokerage experience, attended investment seminars, read investment books, and regularly watched financial television programs (Id., p. 2).

EA, on the other hand, told the NASD investigator that she was an unsophisticated investor and, as noted, that her investment objective was income at all times relevant here (Brief, p. 3; see also, Nellis Aff. para. 9). EA further explained that she relied on Stein's recommendations and trusted him because he promised to handle her account as if it was his mother's (Brief, p. 3; see also, Nellis Aff., para. 9).

2. Discussion

Rule 2310(a), provides that:

> 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, … disclosed by such customer as to his other security holdings and as to his financial situation and needs.

For purposes of this decision, the Panel assumes that EA was not naïve and that she knowingly authorized or acquiesced in all of the transactions, knowing the risks involved. Stein's reliance on such facts nevertheless does not constitute a defense to a charge of making unsuitable recommendations. The Securities and Exchange Commission and the National Adjudicatory Council ("NAC") have made clear that Rule 2310 requires more than simple adherence to a customer's desires. Even where the customer wants to engage in speculative trading, a broker has a duty to refrain from recommending such transactions when doing so would be unsuitable, considering the client's financial situation.[1] Therefore, the test is not whether the client considered the transactions suitable, but whether the representative "fulfilled the obligation he assumed when he undertook to counsel [the client], of making only such recommendations as would be consistent with [the client's] financial situation and needs." In re Eugene J. Erdos, 47 S.E.C. 985, 1983 SEC LEXIS 332, at *10-11 (1988), aff'd, Erdos v. SEC, 742 F.2d 507 (9th Cir. 1984).

If Stein's recommendations were unsuitable for EA, her knowledge and acquiescence were immaterial. The question is not what she knew or wanted, but whether the recommendations were or were not unsuitable for a person in her position. The Panel concludes that they were unsuitable.

As the NAC recently explained, Rule 2310's suitability requirement can be violated when the representative's recommendations are "qualita[tively]" or "quantitatively"

[1] See In re Rafael Pinchas, Exchange Act Rel. No. 41816, 1999 SEC LEXIS 1754, at *22; In re Gordon Scott Venters, 1993 SEC LEXIS 3645, at *6 (1993); Clyde J. Bruff, 50 S.E.C. 1266, 1269 (1992); In re Charles W. Eye, 50 S.E.C. 655, 658 (1991); Department of Enforcement v. Daniel Richard Howard, 2000 NASD Discip. LEXIS 16 (NAC, Nov. 16, 2000).

unsuitable. The former standard is met when the recommendations produce "an undue concentration" of speculative securities, considering the customer's status and financial condition. The latter is met when the recommendations create "excessive trading." Howard, supra.

The Panel finds that the facts of this case demonstrate both kinds of unsuitability. As shown above, it is undisputed that Stein's recommendations led EA to put 50%, then 60%, and ultimately 90% of her account into speculative oil, gas, and metals securities (See CX-1). Indeed, on two occasions, a speculative gold security made up 59% and 92% of EA's account (CX-1; Brief, pp. 5-6). Such holdings constitute an "undue concentration" of speculative securities for a widow, who was 57 years old when her dealings with Stein began and 60 years old when they ended; who had limited fixed income of $25,000 per year in New York City; and who stated that her net worth was $100,000.[2] Cf. Howard, supra (recommendations resulting in 90% holding of speculative securities were unsuitable for a customer with a limited income).

This case also reflects "quantitative" unsuitability through excessive trading. Enforcement argues, and Stein does not dispute, that over various time periods, the account's annualized turnover ratio ranged from 5.12 to 7.62 to 11.56 (Brief, p. 10). As the NAC recently stated, "[t]urnover rates between three and four … have triggered liability for excessive trading, and the courts and the SEC have held that there is little question about the

[2] Stein claims that her actual net worth was "in excess of $150,000," noting the value of her brokerage account with another firm nearly three years after the transactions in issue (Response, p.2, n. 1; p. 8). That post-hoc value has little bearing on EA's status at the time of Stein's recommendations (Reply Brief, pp. 2-3). In any event, Stein's recommendations must be based on the actual information which EA gave to him – not his guesswork about other assets she may have. See Erdos, at *7 ("Under the circumstances, [Erdos] had a duty to proceed with caution; to make recommendations only on the basis of the concrete information that [the client] did supply and not on the basis of guesswork as to the value of other possible assets.").

excessiveness of trading when an annual turnover ratio in an account is greater than six." Howard, supra.

The Hearing Panel also finds it significant that Stein opened a margin account for EA. Such an account involves significant risks. As explained in Stephen Thorlief Rangen, Exchange Act Rel. No. 38486, 1997 SEC LEXIS 762 at *9 (April 8, 1997):

> Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently, giving rise to a margin call in the account. Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain.[3]

Opening a margin account for a person in EA's financial situation was itself unsuitable. The Panel believes that a margin account was inappropriate for EA considering her limited income and net worth – even if Stein explained the risks and she understood them. In this case, "the recommendation of a margin account was incompatible with [the client's] financial profile and was therefore unsuitable." District Bus. Conduct Comm. No. 7 v. Wayne B. Vaughan, 1998 NASD Discip. LEXIS 47, at *19 (NAC, Oct. 22, 1998).

3. Conclusion

The Hearing Panel finds that Stein's recommendations were unsuitable for EA, no matter what her knowledge or intentions may have been. Therefore, the Hearing Panel concludes that Stein violated NASD Conduct Rules 2110 and 2310 by making unsuitable recommendations to EA.

[3] See also NASD Notice to Members 00-61, concerning investor awareness of the risks associated with margin trading.

C. Alleged Registration Violations

1. Facts

As noted, Stein was associated with Josephthal from December 1991 through April 1996; with Greenway from May 1996 through July 1996; and with Joseph Dillon & Company, Inc. from July 1996 through March 1998 (CX-9). While with Greenway and during some months with Dillon, Stein's applications for registration with the State of New York were never approved (Id.). Similarly, while with Greenway, Stein was never registered with the NASD (Id.).

The Second and Third Counts alleged, respectively, that Stein engaged in the securities business in New York (with customer EA) while unregistered by that State and by the NASD. During his association with Greenway, Stein was not listed as the account executive responsible for EA's brokerage account; instead, Barney Kowalski was listed in this capacity (Brief, p. 6; Response, p. 13).

Stein subsequently left Greenway, and, on July 31, 1996, he became associated with Dillon (Brief, p. 7; CX-9). His registration with the State of New York became effective on January 7, 1997 (CX-9). It is undisputed that during the period that Stein was unregistered in New York, Michael Minunno was listed as EA's account representative (Brief, p. 7).

2. Discussion

Rule 1031(a) requires that "representatives" must be registered. The term "representative" is defined as "[p]ersons associated with a member … who are engaged in the … securities business for the member" (Rule 1031(b)). Enforcement contends that during the above unregistered periods of time, Stein was "engaged in the securities business" for Greenway and Dillon through his dealing with EA.

Enforcement relies primarily on its investigator's recital of EA's statements that she dealt with Stein, and not Kowalski or Minunno, during the times in question (Nellis Aff.). Although such hearsay is admissible in NASD proceedings, and in an appropriate case may form the sole basis for findings of fact,[4] before relying on such evidence, "it is necessary to evaluate its probative value and reliability, and the fairness of its use." Tom, at *6. For that purpose, the Hearing Panel must examine five factors: whether the speakers have bias; whether the statements are signed and sworn; whether they are contradicted; whether the speaker was available to provide an affidavit or otherwise testify; and whether the hearsay is corroborated by other reliable testimony. Id. (citations omitted).

Review of the investigator's submission, in light of these factors, raises serious questions about its reliability. The record reflects a strong potential for bias by EA, as she currently has an arbitration claim against Stein and others based on the same issues raised in this case (RX-A; RX-J). Second, although the investigator's statement was sworn to and signed by him, the statements made by EA on which the investigator relies were not given under oath. Third, as for contradiction, Stein has challenged most of the assertions regarding the registration violations made by EA through the investigator. Fourth, the record contains no suggestion that EA was unavailable or somehow unable to execute an affidavit setting forth her allegations. Without any explanation, Enforcement chose instead to rest on the NASD investigator's affidavit as to what EA told him. As for corroboration, there are, as noted, weaknesses in Minunno's statements and nothing from Kowalski. Finally, Enforcement itself acknowledged that the investigator's affidavit contains at least one

[4] See In re Charles D. Tom, Exchange Act Rel. No. 31081, 1992 SEC LEXIS 200 (1992); District Bus. Conduct Comm. v. Harry Gliksman, 1999 NASD Discip. LEXIS 12 (NAC, March 31, 1999); District Bus. Conduct Comm. v. Kevin Lee Otto, 1999 NASD Discip. LEXIS 21 (NAC, June 28, 1999).

inaccuracy (Reply Brief, p. 8). Considering all of these circumstances, the Panel is not persuaded by the investigator's hearsay recital.

Enforcement also presented three statements from Minunno, EA's representative of record at Dillon. The Panel finds them somewhat inconsistent. Minunno first stated that he did not complete EA's new account form; never "personally ask[ed EA] about her investment objectives, risk tolerance, previous investment experience, net worth and annual income;" had no conversations with her about a particular trade; and described his participation in another trade as limited to doing what Stein instructed him to do (CX-10). A second statement, filed in defending against EA's arbitration claim, stated that: "[i]n the time that I was [EA's] Account Executive, only two transactions took place and I kept her well advised on all existing positions regularly" (CX-12; RX-H). A third statement, responding to Enforcement's request for clarification of the first two statements, stated that Minunno sometimes forwarded EA's telephone calls to Stein and that on other occasions he provided EA with price quotations (CX-13; RX-I). In the Panel's view, the shifting tone of Minunno's statements – which Enforcement itself sought to clarify – detracts from their credibility.[5]

There were also evidentiary gaps. The record contains no information as to Kowalski's version of the events. As EA's ostensible registered representative at Greenway, he would have been a significant source as to what Stein may or may not have done regarding her trades. Enforcement says nothing about what Kowalski would have said, and indeed, there is no evidence that the Department ever contacted him. In addition, there was no evidence that Stein, while supposedly acting as EA's representative at Greenway and

[5] That EA followed Stein to these firms does not establish that he "engaged in the securities business" for them while waiting to become registered. Brokers can move to new firms and arrange for one of its registrants to service a customer during the pendency of their own registration applications.

Dillon, received commissions from those firms during the time in question. An absence of such evidence is consistent with the hypothesis that Stein did not act as the registered representative.

3. Conclusion

The unexplained absence of any submission from or pertaining to Kowalski, the absence of any evidence pertaining to Stein's commissions from Greenway and Dillon, the questions raised by Minunno's three statements, and the problems inherent in the investigator's hearsay recital of EA's statements support the conclusion that Enforcement failed to establish the registration violations by a preponderance of the evidence.

III. Sanctions

"In cases involving recommendations of clearly unsuitable securities and no prior similar misconduct" the NASD Sanction Guidelines recommend a fine of $2,500 to $50,000 and a suspension of 10 to 30 business days. For egregious conduct, they recommend a suspension of up to two years or a bar.[6] Enforcement requests that the Hearing Panel bar Stein, emphasizing EA's personal and financial circumstances, the trading history in her account, and Stein's attempt to conceal his activities by changing her investment objectives on her new account forms (Brief, pp. 12-13). The Hearing Panel agrees that the above circumstances make this an egregious case, but concludes that the maximum recommended penalty is not warranted.

[6] NASD Sanction Guidelines, at p. 83 (2d ed. 1998).

Stein's improper recommendations involved only one customer.[7] There was no evidence that he made such recommendations to anyone else and no evidence of "prior similar misconduct" – a factor expressly noted in the Guidelines at p. 83. This record, therefore, reflects an absence of other aggravating factors which could justify sanctions at the upper end of the Guidelines' recommendations.

Furthermore, although EA received regular confirmations and at least two activity letters informing her of the risks associated with her investments and requesting that she inform the firm of any problems with her account (See RX-C, E), she made no complaint until her account began to lose value. Finally, Stein's suitability violations were not linked to or accompanied by other wrongdoing, a circumstance which also could support the imposition of a bar.[8]

On balance, therefore, the Hearing Panel concludes that a suspension of one year and a fine of $25,000 are appropriate sanctions for this violation. These sanctions reflect the Hearing Panel's view that although Stein acted egregiously, there were several countervailing factors which warranted a sanction in the middle of the range set forth in the Guidelines.

IV. Conclusion

Respondent Jack H. Stein violated NASD Conduct Rules 2110 and 2310 by making unsuitable recommendations to customer EA. Stein is fined $25,000 and suspended for a period of one year from association with any NASD member firm in any capacity for such violations. These sanctions shall become effective on a date set by the Association, but not

[7] See District Bus. Conduct Comm. No. 7 v. Wayne B. Vaughan, No. C07960105, 1998 NASD Discip. LEXIS 47, at *23 (NAC, Oct. 22, 1998); District Bus. Conduct Comm. No. 9 v. Michael R. Euripides, No. C9B950014, 1997 NASD Discip. LEXIS 45, at *27 (NBCC, July 28, 1997).

earlier than 30 days after the final disciplinary action of the Association. If this decision becomes the final disciplinary action of the association, the suspension as to Respondent Stein shall become effective with the opening of business on Monday, May 7, 2001 and end at the close of business on Monday, May 6, 2002.[9]

HEARING PANEL

By: Jerome Nelson
Hearing Officer

Dated: Washington, DC
March 6, 2001

Copies to: Jack H. Stein (via overnight delivery and first class mail)
Neil S. Baritz, Esq. (via facsimile and first class mail)
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[8] See In re Maximo Justo Guevara, Exchange Act Rel. No. 42793, 2000 SEC LEXIS 986 (2000).

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