NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Frank Rocky Mazzei (CRD # 2162699), College Park, Maryland and Oceanport, New Jersey and GKN Securities Corporation New York, New York, Respondent.	Disciplinary Proceeding No. C10970120 DECISION Hearing Officer - JN June 24, 1998

Digest

The Department of Enforcement filed a Complaint alleging violations of Rules 2110, 2120, 2310, and 2510. The First Cause alleged that Respondent made unsuitable recommendations and churned a customer's account. The second cause alleged that he made material misrepresentations and omissions. The Hearing Panel found that Respondent had committed the violations as alleged. The Panel censured the Respondent, and ordered (1) restitution in the amount of $41,974.89, plus interest, (2) suspension for six months, subject to reduction for earlier payment of restitution, and (3) a total of $24,087 in fines.

Appearances

1. Mari B. Maloney, Regional Attorney, Department of Enforcement.

2. Leonard J. Amoruso, Chief Counsel, District 10, Department of Enforcement.

3. Rory C. Flynn, Chief Litigation Counsel, Department of Enforcement.

4. Morgan W. Bentley, Counsel for Frank Rocky Mazzei.

I. BACKGROUND

On October 20, 1997, the Department of Enforcement (Department) filed a Complaint charging Respondent Mazzei with several violations of NASD Conduct Rules. The First Cause alleged that Respondent (1) made unsuitable investment recommendations to customer RB, considering that customer's financial situation, needs, and stated investment objectives, and (2) engaged in churning of that customer's accounts. These allegations rested on Conduct Rules 2110, 2310, 2510, and 2120. The Second Cause alleged that Respondent made material misrepresentations and omissions about an "activity letter" which Respondent's firm sent to the customer. Those allegations rested on Conduct Rules 2110 and 2120.

The Hearing Panel conducted hearings in New York City on February 10 and 11, 1998. The Hearing Officer admitted 32 exhibits offered by the Department and one exhibit offered by the Respondent.[1] The Panel heard testimony from seven witnesses. Three of the Department's witnesses, including the customer, testified by telephone, after having been sworn by notaries.[2]

---

[1] The Department's exhibits are referred to as "CX"; Respondent's exhibit is referred to as "RX".

[2] The Department filed a pre-hearing motion for permission to allow the customer to testify by telephone because of his physical condition ("Pre-Hearing Submission," p. 7). Counsel for Respondent had no objection to the telephone

Respondent, a registered representative associated with Gruntal & Co. during the relevant time, persuaded customer RB to open a joint account (with his wife) and an IRA account. Respondent opened these accounts with Comverse stock which he owned. This case involves a series of purchases and sales, executed by Respondent between October of 1994 and June of 1995, in those accounts. The parties agree that the transactions occurred, and are accurately set out in Exhibits CX-26 and CX-27 (Tr. 88-89). Copies of these exhibits are attached to this decision and are hereby incorporated in it as Exhibits A and B. The issues are whether these purchases and sales constituted unsuitable recommendations, considering the customer's financial situation, needs and investment objectives; whether the transactions amounted to churning or excessive trading; and whether Respondent made a material misrepresentation to the customer.

II. THE CUSTOMER, THE ACCOUNTS, AND RESPONDENT

A. The Customer's Financial Situation, Needs, and Investment Objectives

The customer was 64 and 65 years old during the time of these transactions. He was unemployed when he opened the account and at all times thereafter (Tr. 401, 481-482, 504-505). A series of medical problems (diabetes, hypertension, retinal disease, and peripheral neuropathy—a painful condition affecting the back and legs) combined to render him unemployable (Tr. 468-479). RB's wife, who shared the joint account, is three years older than he, and has not worked since 1959 (Tr. 479).

---

testimony (transcript of pre-hearing conference, February 4, 1998, p. 10). In these particular circumstances, the Hearing Officer granted Enforcement's request (Order of February 4, 1998).

In filling out RB's new account forms, Respondent accurately recorded the customer's description of his investment goals as "growth and income" and his employment status as "retired" (Tr. 31-32, 111, 113; CX-5). He also knew RB's age (Tr. 111).

The customer had no pension, and was not receiving Social Security payments during the relevant time (Tr. 507; CX-13, p. 258). When trading began, RB's net worth was $234,418, including his home, automobiles, personal possessions, and the Comverse stock, valued at $84,317 (CX-10). RB's adjusted gross income for 1994 (the year in which he last had some employment and opened the accounts) was $12,074 (CX-9, p.235). His 1995 income was so low that he did not have to file a tax return (Tr. 421). For 1996, his accountant expected the same result—i.e., income so low as to preclude the need for filing a return (Tr. 423).

The customer testified that he had no money to put into the accounts because he was living on whatever he had, and had so informed Respondent (Tr. 506). Respondent said that he had not discussed what money RB had to live on (Tr. 116). RB occasionally asked Respondent to send money from the Gruntal accounts because he needed funds to live on (CX-13, p. 258; Tr. 537-538). Respondent said that he knew of these requests, but not of RB's needs, explaining "[I]t's his money, who am I to ask" (Tr. 190).

B. <u>The Accounts and Respondent's Relationship</u>

Although the account was not discretionary, the customer testified that he "just sort of assumed" that it was, because "I just sort of let him [respondent] do it" (Tr. 540). The customer explained that he had "complete trust" in Respondent, who "inspires trust" (Tr. 524). He said that he liked talking with Respondent (there were many conversations "about a lot of things") and believed that he was "a real money manager" (Tr. 521, 574). He testified that he never instructed

Respondent to buy any particular stock and that Respondent sometimes sold stock without even talking to him (Tr. 520-521, 539).

Respondent acknowledged that he originated all or most of the investment ideas; that he had a "good relationship" of "trust" with the customer; that RB gave him "a free hand pretty much" in selecting stock; that all of the purchases in the joint account were solicited[3]; and that the customer went along with his recommendations "[m]ost of the time" (Tr. 137, 138, 140, 145; CX-19, p. 289). Indeed, Respondent could not recall if there was ever a time when the customer failed to follow his suggestions (Tr. 138).

III. UNSUITABLE RECOMMENDATIONS

The Complaint's allegations set out three separate aspects to violations of the suitability Rule: the recommendations themselves, the use of margin, and the frequency of trading. The Panel believes that each of these grounds, standing alone, would constitute a violation of Rule 2310, and finds that Respondent violated the suitability rule on each of these bases. Considering the customer's age, financial situation, and needs, Respondent had no reasonable basis for believing in the suitability of (1) the particular stocks recommended and purchased, (2) the use of margin in the joint account, or (3) the frequent trading which occurred. The Panel further finds that Respondent acted with reckless disregard for the best interests of his client and thus also violated Rule 2120.[4]

---

[3] All purchases in the IRA account were also solicited (CX-32).

[4] The Complaint also charged the suitability violations under Rule 2120, "the NASD's antifraud provision," which requires proof of scienter. Michael Alan Leeds, 51 S.E.C. 500, 504 (1993). For this element, Enforcement must show that Respondent knowingly intended to deceive, manipulate, or defraud (Aaron v. SEC, 446 U.S. 680 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)), or that he acted with severe recklessness, involving an extreme departure from the standards of ordinary care (Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991)).

Conduct Rule 2310 (a) requires that:

> In recommending to a customer the purchase, sale or exchange of any security, a member [or associated person][5] 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 …financial situation and needs.

Subsection (b) of that Rule further requires that the associated person make reasonable efforts to obtain information concerning the non-institutional customer's financial status, tax status, and investment objectives.

A. <u>Respondent's Recommendations and the Securities Purchased</u>

For the joint account, Respondent bought and then sold: Discovery Zone, Flagstar, Moscom, Purepac, US Long Distance, VLSI Technology, Western Digital and Zitel (CX-26). For the IRA account, he bought and then sold: Aetna, Flagstar, Nextel, Purepac, Resource Mortgage, and Scientific Game Holdings (CX-27).

The customer asked for income and growth, and Respondent chose neither. As to the income objective, Respondent admitted that "I don't see any income stocks" in the eight companies which he purchased for the customer's joint account (Tr. 133). When asked about any income-oriented investments in RB's IRA account, Respondent named two securities, but admitted that selling them after only a few months, as he did, was inconsistent with the income objective (Tr. 129-133).

The securities were never in the accounts long enough to hint at any relationship between their acquisition and the customer's "growth" objective. On an annualized basis, the capital investment in the joint and IRA accounts was "reinvested" or "turned over" 16.79 and 8.32

times, respectively (Tr. 99-100). Moreover, the growth potential of the stocks was debatable; Respondent acknowledged that the strategy he was supposedly following necessarily involved "high volatility" stocks (Tr. 288).

Respondent's asserted reliance on Gruntal recommendations for Western Digital, Purepac, VSLI Technology and Flagstar Companies provides no defense. First, his acquisitions went well beyond these four companies. In any event, the record shows that in three of the four instances, Respondent ignored the recommendations by prematurely disposing of the stock in disregard of the firm's growth predictions.

On November 1, 1994, when Respondent purchased Western Digital, Gruntal contemplated a "year-end" price increase, attributable to Christmas demand, a new product expected at the end of November, and "strong" December growth (CX-20, p. 309). Yet Respondent sold this stock on December 7, 1994. Respondent bought Purepac, which Gruntal recommended for "long-term risk-tolerant growth accounts" (Id. at 314). Respondent sold this stock after two months. On October 28, 1994, Respondent bought VSLI Technology, a company which Gruntal recommended for a "long-term outlook" (Id. at 322). Respondent sold this stock after three months.

Moreover, Gruntal described two of the stocks which Respondent purchased for both the joint and IRA accounts (Flagstar Companies and Purepac), as appropriate for "aggressive growth investors" and for "growth accounts willing to tolerate price volatility" (Id. at 316, 333). Purchasing such securities for the IRA account, where the customer told Respondent that he wanted "something pretty stable" (Tr. 507), was especially egregious.

---

[5] See Rule 0115(a).

For his purchases of two other stocks (Discovery Zone and Scientific Games Holdings), Respondent relied on "Telemarketing Request to Solicit Form[s]" (CX-21), which showed that branch and research managers had approved the stock for "growth" accounts. These forms do not constitute reasonable grounds for believing that the stocks were suitable for customer RB. As Respondent's supervisor at Gruntal explained, these documents were general allocations of shares to a particular broker, without reference to a particular customer (Tr. 313). The forms had nothing to do with RB's particular needs or situation.[6] Moreover, even the "growth" marking became irrelevant when Respondent elected to sell those holdings within a few months of their purchase (CX-26, 27).

1. The Asserted Change in Investment Strategy

Respondent claimed that sometime after opening the account, the customer shifted his investment objectives from "growth" and "income" to "aggressive growth" (Tr. 126-128), characterized by instructions to "take profits" and "limit losses" (Tr. 154, 156, 159, 161, 171). Respondent said that RB "wanted to be active in his account" (Tr. 162), and that his true objective was "trading" (Tr. 268).

Respondent's testimony about the asserted transition was vague and lacking in detail. When asked to identify the time period of RB's supposed conversion to the philosophy of "aggressive growth," Respondent answered "I don't recall" (Tr. 128). Respondent acknowledged that he never specifically said to the customer "[w]e are going to move to an aggressive growth strategy" and that the customer never said to him "I want to move into an aggressive growth

[6] Similarly, Respondent's "Stock Cross Reference" documents (RX-1) show only that he sold several of the same securities to various other customers. This exhibit tells nothing about the suitability of the stock for customer RB, or for any other customer, for that matter.

strategy" (Tr. 247). Nor did Respondent update the account form to show the alleged change in strategy (Tr. 126). When asked whether the "take profit/limit losses" objective had stop losses or any formula, Respondent said "no" (Tr. 248). He further stated that there was no philosophy such as "I'll look for 15 percent, but I'll dump it at 5 percent on the down side" or "such other formula" (Tr. 273). When asked whether he had "any idea sort of what [the customer's] threshold of pain was on the down side," Respondent said "[n]o" (Id.).

When customer RB opened the account, he wanted "something that would pay a dividend, as well as…[s]ome growth" (Tr. 507), and told Respondent that "I really wanted something pretty stable in the IRA" (Tr. 507). There was no evidence of changed circumstance which would support switching to a more aggressive strategy. The customer did not become younger, stronger, or richer at any time during the period when he maintained the Gruntal accounts. He did not inherit money, win the lottery, find work, or otherwise do anything which might remotely support the alleged transition. Indeed, when RB did say something about investment choices, he suggested purchases of IBM, GE, and a railroad seeking to merge (CX-13; Tr. 508-509, 523-524)—suggestions more consistent with growth and income objectives, than with aggressive trading.

The supposed "take profit/limit losses" rationale ultimately collapsed under its own weight. Respondent admitted that many of the sales in RB's joint account were attributable to margin calls (Tr. 245-246, 613-614)--not "fundamental investment decisions"--and that his prior testimony about selling in compliance with instructions to limit losses was "not correct in the true sense of the word; in the true sense of the meaning" (Tr. 615-616). There was also evidence of a prior inconsistent statement concerning another aspect of the transactions. Respondent provided investigative testimony that "I basically went on the company Gruntal's recommendations" in purchasing securities for RB (Tr. 166). In fact, only four of the twelve purchases were supported by Gruntal recommendations (CX-20).

The Panel does not believe that the asserted transition to "aggressive" investing ever occurred. It concludes that, at all relevant times, customer RB's investment objectives were precisely those listed on his new account form: growth and income.

But even if RB did change his investment goals from growth and income to "aggressive growth" that circumstance, standing alone, would not constitute a defense. Respondent's responsibility goes beyond mechanical obedience to all customer demands. As the S.E.C. stated in Clyde J. Bruff, 50 S.E.C. 1266, 1269 (1992):

> [h]aving undertaken to act as an investment counselor for the Pattersons, Bruff was required to make only such recommendations as were in their best interests. Thus even if the Pattersons wished to engage in aggressive and speculative options trading, Bruff was obliged to counsel them in a manner consistent with their financial situation (citations omitted).

See Charles W. Eye, 50 S.E.C. 655, 658 (1991) ("Her request for a plan to increase that income was not a warrant to escalate risks unduly. If the only approach capable of producing the desired income involved significant dangers, Eye should have advised against it"); Eugene J. Erdos, 47 S.E.C. 985, 988 (1983), aff'd, Erdos v. S.E.C., 742 F.2d 507 (9th Cir. 1984) ("Even though Mrs. C. may have desired 'quick profits,' that did not entitle Erdos to ignore her individual situation and place her limited assets in risky investments"); and District Business Conduct Committee v. Michael R. Euripides, No. C9B950014, 1997 NASD Discip. LEXIS 45 at *13 (NBCC, July 28, 1997) (representative has consultative duty when customers wish to engage in trading that is inconsistent with their financial situation).

Respondent violated these principles, even assuming the alleged shift to an investment objective of "aggressive growth." Respondent agreed that "aggressive growth" stocks would necessarily have a "very high volatility" (Tr. 288). There is no evidence that he ever so informed the customer. Respondent himself agreed that based on what he now knows, it "absolutely" would have been prudent to have counselled the customer against an "aggressive growth" strategy (Tr. 268-269). In the circumstances of this customer, Respondent's reaction to RB's supposed goal of "aggressive growth" should have gone well beyond simply buying and selling "high volatility" securities.

2. Respondent's Knowledge of Customer's Personal Circumstances

The customer testified that he told Respondent that his health problems precluded further employment (Tr. 500-502), and that he could not put money into the account because he had to "live off" the money he had, explaining "I don't have anything else" (Tr. 500-502, 506). Respondent denied such conversations (Tr. 116, 208). The Panel believes they did occur.

The Hearing Panel listened to RB at length (Tr. 457-612), and found him to be a talkative individual, who did not spare details concerning his health, his finances or anything else. Respondent must have had some conversations with RB about income; he acknowledged believing that "the only additional income [RB] had coming in" was from rental of a Mississippi house (Tr. 115).[7] Respondent also knew that the customer occasionally asked him for money from the account (Tr. 189-190; CX-19, p. 291). There was no reason for RB, who liked to talk to Respondent "about a lot of things" (Tr. 521, 574), somehow to have remained silent about these important matters.

[7] The customer explained that he stopped renting that house after some difficulty with tenants (Tr. 464-465).

Finally, as noted, Respondent's ultimate admissions concerning the truth of his testimony about RB's purported investment strategy seriously damaged his credibility. The Panel accepts the customer's testimony, and concludes that Respondent did know that the customer was unable to work because of health problems, and was unable to put cash into the account.

In any event, Respondent's claims of ignorance are not defenses. Rule 2310(b) required Respondent to "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…registered representative in making recommendations to the customer."

Respondent said that he never discussed whether the Comverse stock reflected all of RB's money, how the customer would live day-to-day, how the customer would meet margin calls, the customer's net worth, or what percentages RB wanted in growth and income respectively (Tr. 116-118, 128, 129, 240). Respondent's own version of events (exemplified by his "who am I to ask" explanation for ignorance) demonstrates his failure to make reasonable efforts to obtain relevant financial information concerning his customer.

The Panel concludes that Respondent violated Rule 2310 because he had no reasonable grounds for believing that his recommendations were suitable for this customer, and failed to make reasonable efforts to obtain information concerning RB's financial status, tax status, and investment objectives.

B. The Use of Margin

1. Opening a Margin Account

Shortly after opening the customer's joint account with Gruntal, Respondent placed it on a margin basis (CX-5; Tr. 109). The customer said that the idea came from Respondent (Tr. 512), who "talked mostly in a positive way about it. That was making money" (Tr. 524, 563). As to whether the down side could be risky, the customer testified: "I really wasn't too sure about it either way. This was presented to me in this way, and I went along with it" (Id.). RB said that he knew (from Respondent) that margin was a form of buying on credit, and initially resisted such an arrangement (Tr. 512-513). Respondent assured him that someone would be watching and moving in and out fast (Tr. 513). The customer quoted Respondent as having said that "if it goes up, you are margining money. Make more money that way" (Id.). As to risk, RB said that Respondent told him "the only thing that was troubling about it was if it started dropping you had to get out fast; otherwise you would run up a big bill" (Id.). When asked if he had ever heard the term "margin call" as a reason for selling his stock, the customer said "[m]argin call? I'm not sure, I don't think he ever mentioned a margin call. We bought on margin, is that the same thing?" (Tr. 589-590).

Although Respondent said that he had explained the margin system to the customer (Tr. 242), the Panel believes that RB had limited information. He had no prior experience with margin, and had never inquired about it.[8] Respondent admitted that he had not discussed with RB how a margin account would be consistent with his age and annual income (Tr. 128). Nor had he discussed with the customer how he could get money to pay for margin calls, or how he would meet margin calls, if they occurred (Tr. 129). Although Respondent believed that RB's account

---

[8] RB maintained a securities account with another member firm before opening the Gruntal account. That prior account was not a margin account, and RB's previous broker could not recall the customer's ever having inquired about margin (Tr. 372, 409).

was over-leveraged, and agreed that it was his responsibility to so advise the customer, he could not remember having done so (Tr.245, 287-88).

As noted, the record damaged Respondent's credibility. He admitted that a number of sales occurred in order to meet margin calls, not to conform to the customer's supposed investment strategy, and that his prior testimony was "not correct in the true sense of the word" (Tr. 245-246, 615-616). Moreover, as shown supra at p.8, his investigative testimony on another matter proved to be inaccurate (Tr. 166). The Panel concludes that Respondent did not fully inform this customer as to the workings and risks of margin accounts and transactions.

2. Margin Calls

Respondent's transactions in RB's joint account led to a series of margin calls (CX-14). To meet these calls, Respondent sold stock held in the joint account (Tr. 146, 175, 613-614). For example, the record shows that Respondent purchased 4000 shares of Flagstar, Inc. on margin for customer RB's joint account (CX-6, p. 145; CX-14, p. 261). On January 23, 1995, Gruntal issued a margin call, requiring that the customer produce some $16,000 in full payment for that purchase (CX-14, p. 261). The next day, Respondent sold the customer's holding in another stock, receiving some $18,000 (CX-26).

The record reflects a total of ten such margin calls (CX-14), each of which was met by a corresponding sale of stock held in RB's joint account (Tr. 146, 175, 613-614). Respondent agreed that in these circumstances, "a lot of" the sales were instances of "forced liquidation" (Tr. 618). These sales were prompted not by "fundamental investment decisions," but by margin calls (Tr. 245-246).

On February 6, 1995, the customer transferred $10,000 from his IRA account to the joint account (CX-15; Tr. 177, 532-533). This transfer occurred one day before the customer was required to meet a $6,414 margin call (CX-14, p. 262). The customer testified that he had moved the money at Respondent's suggestion, in order to obtain "more leverage" (Tr. 523). Respondent denied that the transfer was his idea, but described this shift of money (supposedly in accord with RB's objectives) as an "opportunity" to "use the margin factor" (Tr. 177).

Margin has advantages and disadvantages. It can enable a customer to purchase greater amounts of securities and thus make more money if things turn out well. It also carries significant risks. As the S.E.C. 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.

All of these adverse impacts fell upon this customer. The Panel concludes that Respondent, working with a trusting customer who had limited knowledge, used margin in such a way as to over-leverage the account. A series of self-created debts, in turn, produced forced liquidations, which eventually led to the invasion of the customer's IRA account (to obtain more leverage), and the depletion of his portfolio. There were no reasonable grounds for believing that this serial trading on margin was suitable for RB, considering his financial situation and need. Indeed, Respondent recognized that the account was over-leveraged, and that this use of margin (coupled with the stock involved) created an unsound investment strategy (Tr. 287-289).

C. The Frequency of Trading

As shown infra in the discussion of "churning" as a separate violation, Respondent engaged in excessive trading of this customer's accounts. The Panel believes that this trading also violates Rule 2310's requirement that a broker have reasonable grounds to believe that recommendations are suitable for the customer.

For much of the hearing, Respondent defended the frequency of the transactions as consistent with RB's desire to continue trading in order to limit losses. Respondent later admitted that this testimony was less than candid, explaining that many of the sales were "forced liquidations," attributable to margin calls and not to some investment strategy (Tr. 615-616). But even if the customer actually told Respondent to turn the stock over nearly 17 times per year (the turnover ratio for the joint account), Respondent would have had an obligation to counsel him against such action. See Bruff and other cases cited supra. The frequent trades lost money and badly injured the customer; they benefited only the Respondent and his firm. Excessive trading necessarily involves activity which is "inconsistent with the customer's objectives and financial situation" (Rangen, at * 13, citation omitted). There were no reasonable grounds for a belief that the frequency of the trades was somehow suitable for this customer.

IV. EXCESSIVE TRADING OR CHURNING

"Churning occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interest." Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981). The prosecution must show that (1) "the trading in his account was excessive in light of [the customer's] investment objectives"; (2) the Respondent exercised "control" over the trading; and (3) Respondent acted with the requisite scienter, i.e. "the intent to defraud or …willful and reckless disregard for the investor's interests,…" (Id.). Because the offense was charged under Rule 2120, the Department had the burden of proving scienter. The Panel concludes that Enforcement proved churning under Rule 2120, and thus necessarily also proved a violation of Rule 2110.

A. Frequency of Trading

The numerous purchases and sales in the joint and IRA accounts created annualized turnover ratios of 16.79 and 8.32 respectively (CX-28). This means that the capital investment in the accounts was turned over or reinvested 16.79 and 8.32 times per year over the assumed twelve month period (Tr. 99-100). The Department also examined the impact of these frequent transactions by using a cost equity ratio, which compares the total costs associated with the accounts with their average monthly equity (Tr. 100). That ratio shows that given the costs (commissions, mark-ups, mark-downs), customer RB would have had to earn returns of 113% and 57% respectively—just to break even in the joint and IRA accounts (Tr. 101). When asked about these numbers, Respondent acknowledged that they were "very, very high" (Tr. 284).

The customer's costs (commissions, mark-up, mark-down, margin interest, and other fees) for the joint account during the period from October 1, 1994 through June 30, 1995 were $14,507.21 (CX-26; Tr. 96). For the IRA account, those costs came to $10,000, incurred between November 1, 1994 and May 26, 1995 (CX-27; Tr. 98). All of these costs reflect "the amount that the customer was actually charged in the account……what the customer actually paid out" (Tr. 103). For the joint account and the IRA account, these costs, in conjunction with trading losses sustained in the sale of securities, led to total losses of $33,357 and $8,617 respectively (CX-26, 27; Tr. 96-98). Respondent's series of trades thus produced some $42,000 in total losses.

The annualized turnover ratios of 16.79 and 8.32 reflect excessive trading. "While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading." Mihara v. Dean Witter & Co., Inc., 619 F.2d 814, 821 (9th Cir. 1980). See e.g. Shearson Lehman Hutton Inc., 49 S.E.C. 1119, 1122 (1998) (turnover rate of 7.4 was excessive); Gerald E. Donnelly, Exchange Act Rel. No. 36690, 61 S.E.C. Docket 31 (January 5, 1996) (turnover rate ranging between 3.7 and 4.4 was excessive). Although there is no "magical" percentage (Donnelly), turnover rates of 16.79 and 8.32 are nevertheless so far bove those deemed excessive in prior cases that they are highly indicative of excessive trading.

The cost equity ratio, showing that customer RB would have had to earn returns of 113% and 57% just to break even in the joint and IRA accounts, is also evidence of excessive trading. Compare, Michael David Sweeney, 50 S.E.C. 761 (1991) (excessive trading where customers would have had to earn returns of 22% to 44% to break even); and Shearson, 49 S.E.C. 1119, at 1121 (excessive trading where customer would have had to earn return of 50%). Even the Respondent acknowledged that the cost equity ratios in this case were "very, very high" (Tr. 284).

Moreover, Respondent bought and sold the customer's securities in short time frames. In the joint account, they were held for periods ranging from about one week to about three months (CX-26). In the IRA account, the holding periods ranged from one day to four months (CX-27). Compare Mihara, 619 F.2d at 821, finding excessive trading where "45% of the securities were held for less than six months, 67% were held for less than nine months, and 82% were held for less than a year."

All of this - high turnover rates, absurdly unrealistic returns just to break even, large commissions, and short holding periods - occurred in the accounts of a retiree with limited income. The Panel concludes that the trading was excessive under any standard.

B. Control of the Accounts

The Panel finds Respondent exercised de facto control over RB's accounts. "[T]he requisite degree of control is met when the client routinely follows the recommendations of the broker." Mihara, 619 F.2d 814, at 821. Quoting Mihara, the S.E.C. found the requisite control in Michael David Sweeney, 50 S.E.C. 761, 765-766 (1991):

> With few exceptions, the customers did not initiate the transactions in their accounts, nor did they fully understand the trading therein. When the customers decided to effect the transactions at issue, they were relying totally on the Sweeneys. Indeed, the Sweeneys' consultations with their customers on investment choices were merely a formality, since the customers invariably followed their recommendations.

See also Erdos v. S.E.C., 742 F.2d 507, 508 (9th Cir. 1984)("Mrs. Cole lacked a sufficient understanding of the trading to evaluate Erdos' recommendations independently….[S]he completely relied upon his advice and always followed his recommendations"); Gerald E. Donnelly, 61 S.E.C. Docket 31, 34, fn. 17 (1996) (customer "relied heavily on Donnelly's advice...and, with respect to most of the trades, approved individual transactions simply on the basis of Donnelly's recommendations….and 'could not remember ever rejecting his advice'").

The evidence in this case (see pp. infra) amply meets these standards.

C. Scienter

The Hearing Panel finds ample evidence that Respondent acted with reckless disregard of the client's interests. As shown in Part IV of this Decision, infra, when the customer received an activity letter, generated precisely because his account exceeded certain established trading and commission levels, Respondent induced him to sign the document, by representing that it was "just a formality." In fact, the letter had great practical significance.

Second, Respondent offered an explanation for the frequent trades (following instructions to "limit losses") which, by his own admission, turned out to be false in many respects. A number of the sales were forced by margin calls, and had nothing to do with any investment strategy, let alone some alleged objective of the customer.

Third, Respondent told the customer and the NASD investigator that his actions were based on Gruntal recommendations or research. Only four of the twelve stocks involved were the subject of such research reports—and Respondent ignored them by selling the stock before the recommended time periods. Solicitation forms for two other stocks were merely general authorizations for Respondent to solicit people; they contained no research or studies. Even if these forms were "recommendations," the asserted bases for the selections existed for only about half of the purchases which Respondent made for RB.

Finally, Respondent admitted that RB's accounts were over-leveraged, and that it was his responsibility to so tell that to the customer; but he could not recall ever having exercised that responsibility. The Panel concludes that Respondent's conduct reflected reckless disregard of the client's interests, and thus evidenced scienter.

V. THE SIGNING OF THE ACTIVITY LETTER

The Complaint's Second Cause alleges that Respondent's action in inducing the customer to sign an activity letter violated Rules 2110 (just and equitable principles of trade) and 2120 (manipulative, deceptive, or other fraudulent device or contrivance). As explained supra, the latter Rule requires that the Department prove scienter. Here, as with churning, the Panel concludes that Respondent's conduct violated the stricter standards of Rule 2120, and thus necessarily also violated Rule 2110.

By letter dated January 28, 1995 (CX-16), Gruntal wrote to RB, asking him:

> …to confirm our understanding that the orders in your account are in accordance with your investment objectives and within your risk capital limits; that you are fully aware of the nature, frequency, risk factors and profits or losses associated with the transactions in your account and the cost of borrowing money to purchase and carry positions on margin; and that you are also aware of the risk factors associated with trading on margin, including the fact that while trading on margin may increase your potential gain, it may also increase your potential loss and your financial exposure could exceed the value of your securities. If our understanding is accurate, please so confirm by signing below and returning this letter in the enclosed stamped envelope. Of course, if our understanding is not correct in any respect, I would appreciate your letting us know this at your earliest opportunity.

On February 6, 1995, the customer signed this letter in the space marked "CONFIRMED" and returned it to Gruntal.

As explained by Respondent's supervisor at Gruntal, the firm's computers generate such documents, known as "activity letters," when account activity or commissions exceed particular levels (CX-23; Tr. 306). An activity letter is a significant event in a customer's account (Tr. 309). If the firm does not receive the signed letter within a certain time, it will "freeze" the account, allowing no further trading (Id.). Alternatively, if the firm receives the signed letter (as was the case with customer RB), "they just put it in the file and they feel everything is okay" (Tr. 310).

The customer testified that when he received the activity letter, he called Respondent, who told him:

> You have to sign this…You've got to sign it, they want this…Gruntal needs this, this is their procedure…They have to have this. Every so often you will get a letter like this. All you have to do is sign it and send it back….so every so often they come out with one of these, it's nothing, just a formality (Tr. 531).

The customer did not remember reading the statements about margin; he did not read the letter carefully because "I thought it was just a formality" (Tr. 531, 569). He could not recall reading the letter, and did not discuss its content with Respondent (Tr. 531-532, 569).

A. Credibility

Respondent denied having told RB that the activity letter was just a formality, stating: "[w]e never talked about this letter" (Tr. 182). The Panel credits the customer's testimony as to this matter, and concludes that RB signed the letter without reading it carefully, following Respondent's urging that he had to sign as a "formality."

The customer signed the activity letter on February 6, 1995—the same date on which he authorized the transfer of $10,000 from his IRA account to the joint account (CX-15). He explained that he did not focus on the activity letter because his mind was on the IRA transfer, which he was discussing with Respondent (Tr. 532). This explanation is consistent with evidence that the transfer was a significant event, which had been the subject of several conversations between the customer and the Respondent, where they had differed over how much to withdraw (Tr. 176-178, 214, 528-529).

Respondent's supervisor could not recall another instance where there was a complaint about an account after a customer signed an activity letter (Tr. 343). The occurrence of this unique situation here would be consistent with the customer's having signed an unread activity letter because the Respondent told him to. Moreover, signing the letter in these circumstances would be natural for one who had "complete trust" in Respondent. Finally, as noted, Respondent's credibility was especially low in this case. His testimony about making sales because of RB's supposed strategy was admittedly incorrect, and his investigative testimony as to reliance on Gruntal research was inconsistent with the fact that such research involved only four of the securities purchased.

B. The Violation

For purposes of Rule 2120, there must be a showing that: (1) misrepresentations and/or omissions were made in connection with the purchase or sale of securities; (2) the misrepresentations and/or omissions were material; and (3) they were made with scienter. Euripides, 1997 NASD Discip. LEXIS 45, at *18. There can be no serious question about the falsity and materiality of Respondent's representation that customer RB should sign the activity letter because it was "just a formality." A Gruntal witness testified that such letters play an important role in the firm's monitoring of accounts, explaining that a refusal to sign would have caused the firm to freeze the customer's account, an action which would have stopped many of the transactions (including margin calls and resulting forced sales) which later occurred. The witness agreed that an activity letter is a "significant event in a customer's account" (Tr. 309). The letter was not a "formality."

The misrepresentation was made in connection with purchases and sales of securities. Gruntal issued the letter because of transactions in securities; the customer's signature allowed Respondent and the firm to continue trading activities.

For materiality, "…there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[9] Here the omitted fact was that the letter was a significant event which would have told the firm that the customer was "fully aware" of:

> …the nature, frequency, risk factors and profits or losses associated with the transactions in your account and the cost of borrowing money to purchase and carry positions on margin; ...the risk factors associated with trading on margin, including the fact that [margin] may also increase your potential loss and your financial exposure could exceed the value of your securities (CX-16).

In fact, the customer was not "fully aware" of the risks or of the purpose of the letter. Disclosure of the facts and of the circumstances which produced the letter would likely cause a reasonable investor to make inquiries. The customer's view of the importance of the omission (albeit after the fact) was reflected in his description of the activity letter as "that letter that I should have read more carefully" and his candid acknowledgment that by signing it, "I really messed up on that one" (Tr. 530, 570).

That portions of this Respondent's representations were correct does not constitute a defense. A material misrepresentation or omission which renders the statement a half-truth is nonetheless violative. E.g., Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 202 (3rd Cir. 1990) (under S.E.C. Rule 10b-5).

Respondent emphasizes that RB signed the activity letter on February 6, 1995, but did not complain to NASD until April 26, 1995. This passage of time establishes only that the customer did not know what was going on until his accountant got involved. To convert this time period

[9] TSC Industries v.Northway, Inc, 426 U.S. 438, 449 (1976). See Basic Incorporated v.Levinson, 485 U.S. 224, 232 (l988), adopting TSC for purposes of Section 10(b) cases.

into a defense would reward the wrongdoer for his deception, while penalizing the unaware victim.

Respondent argues that he should not be held responsible for RB's failure to read a plainly written form. Respondent told RB to sign the letter because the firm needed it and because it was a mere formality; the customer, with "complete trust" in Respondent, followed his instructions without reading the letter carefully. Respondent, having induced RB to sign an important document concerning purchases recommended by himself, cannot shift responsibility to the customer.

VI. SANCTIONS

A. Unsuitable Recommendations

1. Restitution

"Restitution…is a particularly fitting sanction in cases of unsuitable recommendations." David Joseph Dambro, Exchange Act. Rel. No. 32487, 1993 SEC LEXIS 1521, at *14 (June 18, 1993). As the S.E.C. there stated, "[a]s between [the customer], who was placed in an unsuitable investment and Dambro, who recommended it, equity requires Dambro, as the person responsible for the loss, to bear its burden and to return the customer to the position occupied prior to the improper recommendation" (Id., footnote and citations omitted).

As part of the sanction for Respondent's suitability violations (Rules 2110, 2120 2310), Respondent must, therefore, restore customer RB "to the position occupied prior to the improper recommendation." As shown on Enforcement's Exhibits CX-26 and 27 (and stipulated to by Respondent), the customer's losses in the joint account and IRA accounts were $33,357.69 and

$8,617.20 respectively—a total of $41,974.89. Respondent must make restitution of that total, plus interest.

As recommended in the NASD Sanction Guidelines (1998), p. 12, interest should run from the dates of the violative conduct and should be calculated at the rate established for the underpayment of federal income taxes (26 U.S.C. 6621(a)(2)). For restitution purposes, the "violative conduct" is directly reflected in the individual transactional losses, as set out in the in the "Profit/Loss" columns on CX-26 and 27. Interest at the above rate should be calculated from the date of each loss. For example, in the joint account (CX-26), the loss of $692 which occurred on the settlement date of April 20, 1995 must be paid back to the customer, with interest calculated from that date; the loss of $571.06, occurring on the May 2, 1995 settlement date must be repaid to the customer, with interest running from that date, and so on throughout CX-26 and CX-27.

Respondent may make appropriate arrangements with customer RB for payment of the restitution on an installment plan. Respondent shall notify the Association, by letter or form acceptable to it, at such time as restitution has been paid in full in accordance with this decision.

2. Suspension

For suitability violations, the Guidelines suggest that adjudicators consider suspending an individual respondent for 10 to 30 business days, explaining further that suspension for up to two years may be appropriate in egregious cases. For these purposes, the Panel believes that this case is in the "egregious" category, albeit at the low end. As noted, Respondent's unsuitable recommendations reflected reckless disregard of the customer's interests, thereby violating Rule

2120, as well as Rules 2110 and 2310. In the Panel's view, the added element of scienter makes this an egregious case for Guidelines purposes.

But, there were also mitigating circumstances. Respondent, with over three years of industry experience at the time he opened RB's accounts, had no prior disciplinary history. Respondent testified that he had not been the subject of any additional customer complaints during the following years, and there is no evidence to the contrary. His improper recommendations, though egregious as to RB, involved just that one customer.

Respondent learned from this case, explaining, without contradiction, that the RB experience caused him to make more conservative recommendations to clients (Tr. 293). His testimony at the hearing showed some recognition of his own errors - e.g., failure to have counselled RB against his supposed objective; recognition that it was his responsibility to tell the customer that the account was over-leveraged; and acknowledgment that the combination of high volatility stock and an over-leveraged client was not a good investment strategy (Tr. 268-269, 288-289).

In addition, the Panel believes that the firm shares some of the blame. Respondent testified (again without contradiction) that his manager, though periodically reviewing his books, never told him that RB's account - or that of any other customer - was too active or over-leveraged (Tr. 294-295). The co-branch manager of Respondent's group or his delegate would review account statements monthly and order tickets daily, looking at holding periods and debit balances (Tr. 318-319, 321). If he believed that an account was over-leveraged, he would talk to the broker (Tr. 322). This witness did not recall any conversations with Respondent concerning RB's account, did not know whether there were any warnings by Gruntal supervisors or compliance people about the account, and did not hear anyone suggest that the account reflected churning or unsuitable activity (Tr. 322, 329-332). The firm's procedures for activity letters necessarily involve branch managers (CX-23). Although Respondent's co-branch manager or one of his sales managers would normally tell the representative that a letter had gone out, he had no recollection of such a conversation with Respondent (Tr. 307-308).

On balance, therefore, the Panel concludes that a suspension of two months is appropriate for the suitability violations.

The first general principle in the Guidelines is that "[d]isciplinary sanctions are remedial in nature…" (Guidelines at 3). Rule 8310(a)(3) allows the Association to suspend a member for "a period contingent on the performance of a particular act;…" The payment of restitution may properly be the "particular act." See Dambro, 1993 SEC LEXIS 1521, at fn. 22, quoting the S.E.C.'s approval of the relevant NASD rule amendment. To create an incentive for prompt payment of restitution, the Panel thus directs that if Respondent makes full restitution to the customer within the two-month suspension period, the suspensions imposed infra for the churning and misrepresentation violations shall run concurrently with that two-month period. If Respondent makes full restitution after the two-month suspension pertaining to the suitability violation, the suspensions imposed for churning and misrepresentation shall run consecutively.

Although Respondent may make installment payment arrangements with the customer, for purposes of shortening the three-month suspension period, Respondent must make restitution in full within the two-month period.

3. Fine

The Guidelines authorize a fine of $2,500 to $50,000 for suitability violations. The Panel concludes that a fine of $5,000 will be appropriate. This sanction reflects the Panel's view that although the fine should be above the minimum (because Respondent acted recklessly), there were several mitigating factors, as set out above. The Panel considered adding the $9,087 which Respondent wrongfully earned[10] (See Guidelines, at pp. 7 and 83, fn. 2), but decided that this sum should be reflected in the fine for churning.

B. Churning

1. Suspension

The Guidelines recommend suspension for ten to thirty days, and for up to two years in egregious cases (Guidelines, at p. 74). Here again, the Panel believes that because Respondent acted recklessly, his suspension must be more than the minimum ten to thirty days. Considering the mitigating circumstances described above, the suspensions imposed for Respondent's other offenses, and the Department's recommendation that the overall suspension be at least six months, the Panel concludes that Respondent's churning activity warrants a suspension of two months.

2. Fine

For this violation, the Guidelines suggest a fine of between $5,000 and $75,000 (Id. at 74). They also state that "[a]djudicators should consider a respondent's ill-gotten gain when

[10] Respondent said that he received 40% of the total of the columns marked "Commission" and "Mark-up/Mark-down" on CX 26 and 27 (Tr. 287). The joint account shows $1,795.51 and $11,000 in those columns, respectively; the IRA account shows $987.83 and $8,943.70. The totals for the joint account and IRA account are $12,795.51 and $9,922.53, respectively. The combined total is $22,718.05. Forty percent of that total is $9,087.27.

determining the amount of a fine" (Guidelines, at p. 7). The Panel believes that the compensation which Respondent earned by making the trades ($9,087)[11] constitutes an appropriate fine for the churning violation.

The Guidelines also say that adjudicators "may" add the ill-gotten gains to a base fine and thereby increase the sanction (Guidelines, at p. 7, fn. 2, and 74). Such addition is not required, and the Panel believes that such action is not warranted here. Under the sanctions imposed in this case, Respondent must make restitution of nearly $42,000 plus interest, and pay $24,087 in fines. The Panel concludes that these numbers represent sufficient financial burdens to serve the remedial and deterrent purposes of the process, and declines to enlarge the fine beyond the $9,087 in commissions.

C. Misrepresentation

1. Suspension

For intentional or reckless misrepresentations or omissions, as found here, the Guidelines recommend suspension "for 10 business days to two years" (Id. at 80). The Panel concludes that a two-month suspension reflects the appropriate balance between the recklessness of the conduct and the mitigating circumstances.

2. Fine

The recommended fine for intentional or reckless violations is $10,000 to $100,000. In this case the Panel imposes a $10,000 fine. Although it is the minimum, such a fine is a significant sum (especially when added to the $5,000 and $9,000 fines for the unsuitability and the churning).

[11] See footnote 10supra.

Considering the mitigating circumstances noted earlier in this decision, the Panel concludes that $10,000 is an appropriate fine for this violation.

D. General Considerations as to Fines

Respondent may make appropriate arrangements with the Association for the installment payment of the fines imposed in this case. Because of the remedial purpose underlying restitution, the Panel believes that as a matter of timing, Respondent should make full restitution before paying these fines.

E. Conclusion

Respondent is censured for each of the above violations. For the unsuitability violation, Respondent is also ordered to make restitution to customer RB of the sum of $41,974.89, with interest calculated in accordance with this decision; suspended in all capacities for a period of two months; and fined $5,000. For the churning, Respondent is also suspended in all capacities for a period of two months, and fined $9,087. For the misrepresentation violation, Respondent is also suspended in all capacities for two months; and fined $10,000.

The combined fines for all of the violations found in this decision total $24,087.[12]

The suspensions imposed for each of the violations found shall run consecutively, unless Respondent pays the required restitution in full during the two-month suspension imposed for the suitability violation. If Respondent makes such payment during that period, the suspensions imposed for churning and misrepresentation shall run concurrently with the suspension imposed

---

[12] The Department suggested a fine of at least $20,000 (Tr. 637).

for the suitability violation. The total period of suspension shall thus be either two months or six months,[13] depending upon the time of full restitution.

In addition, Respondent shall be required to requalify by examination before acting in any capacity which requires qualification. The costs of the hearing ($4,109.58) also are assessed against Respondent. As a matter of timing, Respondent should make restitution before paying these costs.

These sanctions shall become effective on a date set by the Association, but not before the expiration of 45 days after the date of this decision.[14]

Hearing Panel

By______________
Jerome Nelson
Hearing Officer

Copies to:
Mari B. Maloney, Esq. (via facsimile and first class mail)
Rory C. Flynn, Esq. (via first class mail)
Morgan W. Bentley, Esq. (via facsimile and first class mail)
Frank Rocky Mazzei (via certified and first class mail)

---

[13] The Department suggested a suspension of six months to one year (Tr. 639).

[14] All of the parties' arguments have been considered by the Hearing Panel. To the extent that they are inconsistent with this decision, they are rejected; to the extent that they are consistent with it, they are sustained.