NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant v. HENNION & WALSH, INC. (CRD No. 25766) RICHARD HENNION (CRD No. 1315386) WILLIAM W.WALSH (CRD No. 1174993) Respondents.	Disciplinary Proceeding No. C9B040013 Hearing Officer – DMF **HEARING PANEL DECISION** January 10, 2005

Respondent Hennion made unsuitable recommendations to a customer, in violation of Rules 2310, 2510(a) and 2110, and exercised discretion in the customer's account without written authorization, in violation of Rules 2510(b) and 2110. For these violations, he is suspended in all capacities for four months, fined a total of $35,000 and required to requalify in all capacities. Respondent Walsh failed to exercise reasonable supervision over Hennion, in violation of Rules 3010 and 2110. For that violation, he is suspended in all supervisory capacities for four months, fined $25,000 and required to requalify in all principal capacities. Respondent Hennion & Walsh, Inc. failed to have reasonable supervisory procedures, in violation of Rules 3010 and 2110. For that violation, it is fined $10,000 and ordered to retain a consultant to review its relevant supervisory procedures. Respondents, jointly and severally, are also fined an additional $40,000, which represents the approximate gain to Respondents from their violations.

Appearances

David B. Klafter, Esq., Woodbridge, NJ, (Rory C. Flynn, Washington, DC, Of Counsel) for Complainant.

Brian F. Amery, Esq., and Daniel J. Reiser, Esq., Morristown, NJ, for Respondents.

DECISION

I. Procedural History

The Department of Enforcement filed a four-cause Complaint on February 20, 2004, against Respondents Hennion & Walsh, Inc. (H&W), Richard Hennion and William W. Walsh. The first cause of the Complaint charged that Hennion recommended or effected unsuitable trades in a customer's account, in violation of NASD Rules 2310, 2510(a) and 2110; the second cause charged that Hennion exercised discretion in the customer's account without having obtained prior written authorization from the customer, and without H&W's prior written acceptance of the customer's account as a discretionary account, in violation of Rules 2510(b) and 2110; the third cause charged that Walsh failed to exercise reasonable supervision over Hennion's trading in the customer's account, in violation of Rules 3010 and 2110; and the fourth cause charged that H&W failed to establish reasonable supervisory procedures, in violation of Rules 3010 and 2110.

The Respondents filed an Answer contesting the charges, and requested a hearing, which was held in Woodbridge, NJ on September 29 and 30, 2004, before a Hearing Panel that included the Hearing Officer, a member of the District 11 Committee and a former member of the District 9 Committee.[1]

[1] In this decision, the transcript of the hearing is cited "Tr."; Complainant's exhibits are cited "CX" and Respondents' exhibits are cited "RX."

II. Facts

H&W has been a member of NASD since 1990.[2] It is a registered broker-dealer and member of NASD located in Parsippany, New Jersey, with approximately 100 employees, about 75 of them registered. Hennion and Walsh own 50% of H&W each. Walsh serves as the firm's president, while Hennion is the firm's vice-president. Both Hennion and Walsh are registered with NASD in various capacities, including as general securities principals and general securities representatives. Approximately 80% of the firm's business involves municipal securities, but H&W is a full service firm that also deals in stocks, mutual funds and unit investment trusts. The firm's customer base is elderly, and the majority of its clients are retired. Hennion, himself, has about 350 customers. Many use him only for municipal securities transactions, but others use him as a full-service broker, purchasing stocks, as well as bonds. Hennion focuses on stocks in the pharmaceutical and biotechnology industries. (Tr. 195-97, 200-01; CX 1-4.)

This case arises out of certain transactions in the account of an H&W customer, ME, during the period January 2000 through March 2001.[3] ME opened her account with H&W in the mid-1990's, when she was approximately 80 years old, in response to a telephone call. Initially, her account was serviced by an H&W representative, but after that representative left H&W in 1995, Hennion personally serviced the account. In 1996, ME executed a margin agreement for her H&W account. ME closed her H&W account in 2001, after the period at issue in this proceeding. (Tr. 136, 206-07; CX 1, 6-7, RX 26)

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[2] H&W was formerly known as Nori, Hennion & Walsh.

[3] Enforcement focused on this period because the case arose out of a routine examination of HW for the period January 1 through December 31, 2000 that was conducted during the first quarter of 2001. (Tr. 42, 55-56.)

ME was born in July 1914, and has been widowed since 1985. ME is a college graduate and worked as a high school teacher, as well as in other capacities, but during the relevant period she was retired. Apart from her investments, ME's income included a teacher's pension and social security. According to her federal income tax returns, during the period 1998 through 2003, ME's adjusted gross income was between $20,000 and $37,000, except in 2000.[4] Her expenses included home care, medications to treat various conditions including arthritis, high blood pressure and heart problems, and utilities and other living costs. At all relevant times she was hearing-impaired, which sometimes made it difficult for her to converse on the telephone. In late 1999, just prior to the period in question, she suffered two broken hips and spent several weeks in the hospital, and she suffered another broken hip in 2001, after the relevant period. (Tr. 145; CX 6, 14.)[5]

ME had experience as an investor. When she opened her H&W account, she had several accounts at other NASD member firms, most of them small, that she later closed, transferring her holdings to H&W, prior to the period at issue. (RX 20, 22, 23, 24, 35.) In addition, during the period at issue she had small accounts at another broker-dealer, with the representative who had opened her H&W account, and at a commodities firm. (RX 19, 24.) ME testified that she had subscribed to financial magazines in the past, and

[4] For 2000, as a result of the trading in her account, ME recognized more than $159,000 in capital gains for federal income tax purposes, and paid nearly $35,000 in federal income tax, compared to $3,500 or less for each of the other years from 1998 through 2003. (RX 30.)

[5] ME, who is now 90, did not testify at the hearing. CX 6, RX 28 and 29 are declarations signed by ME, CX 7 is videotaped testimony that she gave to NASD staff in June 2001 during the staff's investigation, and RX 26 is a transcript of her videotaped testimony. The Hearing Panel viewed the videotape during the hearing and found ME to be a credible witness, although it is clear that her recollection about some details, such as the identity of the H&W representative who first contacted her, was faulty. Respondents objected to ME's videotaped testimony because they did not have an opportunity to take part and question her, but they were not entitled to participate in testimony gathered by the staff during its investigation, and hearsay evidence, such as the videotape, is admissible in NASD proceedings. The Hearing Panel, however, found it unnecessary to rely on ME's testimony alone to resolve any contested factual issues.

that in her prior accounts she made most of the investment decisions herself, in consultation with her registered representative. In contrast, she "completely depended on" Hennion. (RX 26, at 11-12, 20.)

Hennion acknowledged that ME relied on his investment advice and that he recommended 99% of the trades in ME's account. He also testified that he utilized his discretion in effecting some of the trades in ME's account – he could not identify which ones – when he was unable to reach ME. (Tr. 140, 265, 300, 303-04.)

According to Hennion, during the relevant period he believed that ME's liquid net worth was about $500,000 and her annual income was about $50,000, and she had "varied investment objectives," which included speculation.[6] (Tr. 219-20.) Hennion knew that ME was elderly, a widow and retired, and that she had difficulty hearing, had health problems and had been hospitalized. He also believed that she had securities accounts away from H&W, but was not aware of the value of those accounts, and he felt that "she did not have huge expenses." (Tr. 136, 139, 171, 215, 310-13; RX 30.)

During the 15-month period in question, Hennion effected more than $1.7 million in total purchases in ME's H&W account, which had an average monthly equity of $221,000, an annualized turnover ratio of 6.220.[7] During the period, the account incurred

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[6] According to an "updated" H&W new account application dated December 1996, ME's annual income was $30,000, her net worth was $400,000 to $500,000 and her investment objective was tax-free income. (Tr. 211; CX 5.) In an undated Confidential Questionnaire that Hennion testified ME completed in 1998, ME indicated that her liquid net worth was $250,000 to $499,000, and that her investment objectives included "Tax-Advantage," "Safety," "Income," "Growth," and "Speculation." (Tr. 213-15; RX 6.) In another undated Confidential Questionnaire that Hennion testified ME completed in 2001, she indicated that her objectives included "Tax Free," "Income," "Growth" and "Safety." (Tr. 215-16; RX 6.)

[7] Turnover ratio is a well-accepted tool in evaluating the activity level of a securities account. "The turnover ratio is calculated by applying the 'Looper formula,' named after In re Looper & Co., 38 S.E.C. 294 (1958), which divides the total cost of purchases made during a given period by the average monthly investment. … The turnover ratio is computed 'by dividing the aggregate amount of the purchases by the average cumulative monthly investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under

total commissions of more than $40,000, an annualized commission/equity rate that exceeded 15%. Furthermore, ME's account had substantial margin balances during this period, ranging as high as $178,000, and she paid total margin interest of more than $9,500. Her total monthly fees (commissions plus margin costs) for the period exceeded $50,000, an annualized cost/equity rate of more than 19%.[8] (Tr. 57-60; CX 8, 16.)

Many of the transactions in ME's account during this period involved pharmaceutical and biotechnology stocks, including Cytogen Corporation, Applera Corp. – Celera Genomics Group, Peregrine Pharmaceuticals, Inc. and Vivus, Inc.[9] During this period, ME's Cytogen holdings, alone, represented 9-24% of ME's total account portfolio at the end of each month, and 17-44% of the equity value of the account; at various times, the other biotechnology stocks also represented substantial portions of ME's account portfolio and equity value. As of March 31, 2001, the end of the relevant period, the priced securities in her account had a total value of approximately $230,000,[10] but the margin balance in her account was more than $83,000, leaving a net account equity of

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consideration.' ... A modified Looper formula divides the total cost of purchases by the average monthly equity." DBCC v. Pinchas, 1998 NASD Discip. LEXIS 59 at n. 6 (NAC June 12, 1998) (citations omitted), aff'd, 1999 SEC LEXIS 1754 (Sept. 1, 1999).

[8] The cost/equity rate "is sometimes expressed as the 'break-even cost factor.' The phrases refer to identical calculations. ... This calculation represents the percentage of return on the customer's average net equity needed to pay broker/dealer commissions and other expenses, such as margin interest. Put another way, because of the transaction costs related to trading, the account would need to appreciate that amount to break even." DBCC v. Pinchas, 1998 NASD Discip. LEXIS 59 at n. 7 (citations omitted).

[9] During the period, Hennion effected approximately 16 purchases and 13 sales of Cytogen, approximately 11 purchases and 10 sales of Applera/Celera, approximately 9 purchases and three sales of Peregrine and approximately six purchases and five sales of Vivus. NASD staff cited a higher number of trades, but Hennion testified that in most cases where multiple purchases or sales were effected on a single day, they reflected a single order that was broken into parts when executed to obtain the best price for the customer. (Tr. 67, 160-63.) Accordingly, when there were multiple purchase or sale trades on a single day, the Panel treated them as a single purchase or sale.

[10] This amount included approximately $128,000 in biotechnology stocks, $10,000 in a biotechnology mutual fund and $93,000 in fixed income investments.

approximately $147,000, yet during that month alone, total purchases in her account exceeded $240,000. (Tr. 68-69; CX 8, 17, 18.)

In general, during the period in question ME's account held the biotechnology stocks it purchased for only short periods of time, sometimes only a few days. Hennion described the account's activity in these stocks as "trading," a characterization with which the Panel agrees. (Tr. 158-59.) Over the period in question, the equity value of ME's account diminished by approximately $4,200. (CX 8, 19.)[11] For the biotechnology stocks, however, her results were mixed; ME had substantial overall gains in some, and losses in others. (RX 14.)

Hennion testified that he "believed the trading in the account was suitable for [ME] because, Number 1, it was what the client wished to do," emphasizing that ME "asked me to try to trade for profits." (Tr. 169.) ME agreed that she asked Hennion to be more aggressive and to actively trade her account "when I realized that I was going to have to go to a nursing home, that I was going to have to have more help and so I needed to have more money come in from the income." She also testified, however, that "[s]afety was important – very important, and I wanted growth so I could help people." (RX 26 at 23, 35.)

Hennion acknowledged that "biotechnology stocks are speculative investments and are risky," but he explained that he specialized in pharmaceutical and biotechnology stocks and followed each company closely. His wife, also an H&W registered

[11] This amount is calculated by comparing the equity value of the account on January 1, 2000 with the equity value of the account on March 31, 2001, with adjustments for deposits to and withdrawals from the account. The staff's calculation in CX 19, which indicates that ME suffered a loss of nearly $60,000 during the relevant period, is flawed, because the calculations are based on the value of the account on January 31, 2000, rather than January 1. Properly calculated, based on the account's value on January 1, 2000, ME's losses during the relevant period were approximately $4,200.

representative, was educated in chemistry and worked in the pharmaceutical industry before entering the securities industry, which, Hennion believed, enhanced her ability to evaluate the prospects of pharmaceutical companies. He worked closely with her in evaluating firms on a continuing basis, including reviewing technical literature on the companies' product development activities, and he monitored the stocks closely, in terms of price fluctuations, volume and news. With respect to Cytogen, in particular, he "followed this stock daily, all day long." (Tr. 191-92, 201-04, 248, 250, 257-63, 269.)

Hennion testified that "[b]ased on her past experience in the different securities she purchased in the past, the different brokerage accounts that she had, and the risk tolerance that [ME] had, I felt that trading these stocks … was in her best interest." (Tr. 169-70.) In that regard, he cited a number of investments by ME in her other accounts, including certain stock and high-yield bond mutual funds, a gold fund, a limited partnership in the film industry and a commodity investment. (Tr. 224-240.)

Hennion also pointed out that one of ME's other accounts was a margin account, and that ME had a margin balance in that account of approximately $18,000 when she transferred it to H&W in November 1997. (Tr. 230-32; RX 24, 31 at 90.) Hennion acknowledged, however, that the margin balance in ME's H&W account "did get away from us a little bit." (Tr. 170.) Apart from February 2000, during the period in question the month-end margin balance in ME's account was between $51,000 and $178,000, exceeded $100,000 on five occasions and averaged more than $90,000. (CX 16.) Hennion admitted that he "should not have let the margin balance get that high [$178,000]," and that it placed ME at great risk, but explained that he "was caught up, I guess, in the euphoria of what was going on in the market." (Tr. 174.)

As noted above, Hennion acknowledged that he exercised discretion in trading ME's account, saying he did that as an accommodation to ME, who was not always available to approve trades. He admitted that he did not have written authorization from ME to exercise discretion, and that H&W did not accept ME's account, in writing, as a discretionary account. He also knew that H&W's written procedures prohibited discretionary accounts. (Tr. 142-43; CX 9.)

For his part, Walsh admitted that he knew Hennion was exercising discretion in ME's account. He also knew that Hennion's discretionary authority had not been formalized in writing, and he knew that the firm's policy was that "we don't have discretionary accounts." Nevertheless, he allowed Hennion to use discretion in trading ME's account because he believed that Hennion was familiar with ME and that she had asked him to exercise discretion when she was unavailable. (Tr. 335, 353.) He was aware that ME was a widow in her 80s and had been in and out of hospitals, and he knew that Hennion was actively trading the account. (Tr. 351-52.) They "had discussions on what was going on in the account," but he was not aware that the account had concentrated positions in biotechnology stocks, or that the margin balance in the account at times exceeded $100,000. (Tr. 354-55.) Walsh felt that "[i]t was never in my eyes something that I was responsible for," so he never took any steps to require Hennion to stop his activities in ME's account, or to require any sort of corrective measures. (Tr. 354, 363.) In any event, he "would defer to [Hennion's] recommendations" with respect to ME's account. (Tr. 354.)

Walsh acknowledged that under the firm's written procedures, even he, as president of the firm, did not have authority to authorize a discretionary account, and that,

because the firm was not supposed to have discretionary accounts, there was no one in the firm designated to carry out the responsibilities set forth in Rule 2510. As a result, he "can't guarantee" that anyone at the firm performed those functions. (Tr. 378-80; CX 9.)

More generally, Walsh acknowledged that, as president of the firm, it was his responsibility to ensure that H&W had an adequate supervisory system in place, including adequate written supervisory procedures. He testified, however, that he was not aware that NASD's rules require that each registered person be assigned to a properly qualified supervisor, and although he knew generally that "everybody has to be supervised," he was unaware that at the relevant time H&W's written procedures did not designate any supervisor for Hennion. (Tr. 337-38.) He believed that the firm's compliance person was responsible for reviewing customer accounts on a monthly basis, but he acknowledged that the firm's written procedures did not specifically designate anyone to perform that task. (Tr. 331-32.) And although Walsh believed that the compliance person reviewed customer accounts for excessive trading or suitability issues, he was unsure how he accomplished that task. (Tr. 343.) Walsh testified that every day he, himself, reviewed all the firm's trades for the prior day, but also admitted that he has never questioned a trade based on suitability concerns. (Tr. 351.)

III. Discussion

A. Suitability

The first cause of the Complaint charges that Hennion violated NASD Rules 2310, 2510(a) and 2110 by recommending and effecting unsuitable transactions in ME's

account during the period January 2000 through March 2001. Rule 2310(a) requires that, in recommending the purchase or sale of a security, a member or associated person must have a reasonable basis for believing that the recommendation is suitable for the customer, based on the facts disclosed by the customer as to her other security holdings and her financial situation and needs.[12] Rule 2310(b) requires that a member or associated person make reasonable efforts to obtain information concerning the customer's financial and tax status, and investment objectives before executing a recommended transaction. These obligations also apply to transactions effected by the member or associated person through the use of discretion in the customer's account.[13]

The Complaint alleges that Hennion did not have a reasonable basis for the trades he recommended and effected in ME's account during the January 2000 through March 2001 period.[14] In particular, the Complaint focuses on the size and frequency of the trades, the use of margin in the account, and the concentration of the account in speculative biotechnology stocks, considering ME's financial situation, investment objectives and needs.

Hennion knew that ME was an elderly, retired woman of limited means. Hennion says that, at the time, he believed that her yearly income was about $50,000 and her

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[12] Although Rule 2310 refers to the member's obligations, Rule 0115 provides, "Persons associated with a member shall have the same duties and obligations as the member under these Rules."

[13] See, e.g., Department of Enforcement v. Lu, No. C9A020052, 2004 NASD Discip. LEXIS 8 (NAC May 13, 2004), appeal pending, No. 3-11522 (SEC June 15, 2004) ("When a broker effects transactions in an account over which he has discretionary authority, the transactions are implicitly recommended").

[14] Respondents object that the period selected by Enforcement is arbitrary, but the suitability obligation applies to every transaction recommended for a customer's account, so it is appropriate to examine any period during which an account is open for suitability violations.

liquid assets were about $500,000.[15] He also knew that ME had significant health problems, which had required hospitalization. Nevertheless, he recommended, and through the use of discretion effected, substantial trading in speculative biotechnology stocks on margin in her account.

"Depending on a particular customer's situation and account objectives, the extent of trading alone may render transactions unsuitable." Paul C. Kettler, 51 S.E.C. 30, 32 (1992).

> The first step in analyzing an action based on excessive trading is to determine whether the representative controlled the account. This element is satisfied if the account is discretionary. … The first element can also be satisfied by a showing of de facto control. De facto control of an account may be established where the client habitually follows the advice of the broker.

DBCC v. Pinchas, 1998 NASD Discip. LEXIS 59 (NAC June 12, 1998), aff'd, 1999 SEC LEXIS 1754 (Sept. 1, 1999) (citations omitted). In this case, Hennion admits that he recommended 99% of the trades in ME's account and exercised discretion as to some undefined portion of the transactions, which is consistent with ME's testimony that she completely depended on Hennion. Therefore, Hennion controlled the account for purposes of an excessive trading analysis.

> After a showing of control of the account is made, the next step is to determine whether the trading activity was in fact excessive. There is no single test for making such a determination. … Nonetheless, factors such as the turnover ratio, the cost-equity ratio, the use of "in and out" trading, and the number and frequency of trades in an account introduce some measure of objectivity or certainty into the analysis and provide a basis for a finding of excessive trading. … Turnover rates between three and four, for instance, have triggered liability for excessive trading, and the courts and the SEC have held that there is little

[15] In fact, ME's tax returns show that her income, apart from capital gains that she recognized in 2000 as a result of Hennion's trading in her H&W account, was less than $50,000. In addition, there is no evidence that ME had substantial liquid assets apart from her holdings in her H&W account. Nevertheless, for purposes of this decision, the Hearing Panel accepts Hennion's figures for purposes of determining whether he had a reasonable basis for his recommendations.

> question about the excessiveness of trading when an annual turnover rate in an account is greater than six. Excessive trading has also been found in cases in which the cost-equity was between 15 and 30 percent, or more.

Id. (footnotes omitted).

As explained above, during the relevant period, ME's account had an annualized turnover ratio of 6.220, an annualized commission/equity ratio in excess of 15% and an annualized cost/equity rate of more than 19%. Thus, Hennion's trading was excessive under established standards. Although Hennion may have believed the trading in the account was suitable because ME wanted him to trade the account actively, it is well established that "[e]ven if a customer seeks to engage in highly speculative or otherwise aggressive trading, a broker is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile." Department of Enforcement v. Lu, No. C9A020052, 2004 NASD Discip. LEXIS 8 (NAC May 13, 2004).

Hennion traded biotechnology stocks that he acknowledged were speculative investments. Hennion argues that he had a reasonable basis for believing that speculative stocks were suitable for ME because she had indicated in a 1998 Confidential Questionnaire that "Speculation" was one of her investment objectives.

> A customer's investment objectives, however, are but one factor to consider in determining whether the broker's recommendations were suitable for the customer. Furthermore, a broker cannot rely upon a customer's investment objectives to justify a series of unsuitable recommendations that may comport with the customer's stated investment objectives but are nonetheless not suitable for the customer, given the customer's financial profile.

Department of Enforcement v. Chase, No. C8A990081, 2001 NASD Discip. LEXIS 30 (NAC Aug. 15, 2001). In this case, it should have been obvious to Hennion that

speculative trading, resulting in concentrated positions in biotechnology stocks, was not suitable for an elderly widow with limited financial resources.[16]

Hennion also relied on his assessment of ME's "risk tolerance," as reflected in various investments that ME had made away from H&W, such as certain stock and high-yield bond mutual funds, a gold fund, a limited partnership in the film industry and a commodity investment. "A customer's prior transactions, however, are not relevant in a suitability determination …." DBCC v. Vaughan, No. C07960105, 1998 NASD Discip. LEXIS 47 (NAC, Oct. 22, 1998) (citations omitted). Moreover, the evidence regarding ME's other accounts indicates that she invested primarily in bonds and mutual funds, and that any investments that could be characterized as speculative represented at most a small portion of her overall portfolio.[17] There is no evidence that ME had a history of active stock trading.

Hennion also relies on the fact that ME had a margin account at another firm, but by itself that did not support a reasonable inference that ME understood the additional risks from trading on margin, particularly at the level that Hennion traded her H&W account. Indeed, in her videotaped testimony, ME responded to a question about whether she had previously had margin accounts: "I'm sorry, I don't know what margin accounts mean[s]." (RX 26 at 18.) In any event, Hennion had an independent obligation to determine whether trading that resulted in substantial margin balances was suitable for

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[16] Cf. Department of Enforcement v. Stein, No. C07000003, 2001 NASD Discip. LEXIS 38, *9 (NAC Dec. 3, 2001) ("we find that the investment strategy that Stein recommended for [the customer] resulted in [the customer's] investing in stocks that were too risky for someone with her modest income and net worth and that Stein concentrated an excessive portion of [the customer's] portfolio in a non-diverse, limited number of speculative securities, thereby increasing [the customer's] risk of loss").

[17] For example, Hennion points to a commodity investment by ME in nickel, but the total amount of that investment was less than $7,000. (Tr. 234; RX 25.)

ME, and given her age, financial circumstances and needs, clearly it was not.[18] Hennion, himself, acknowledged that as a result of his trading the high margin balance in ME's account placed her at great risk, blaming that on his being "caught up … in the euphoria" of the market. "Euphoria," however, is no excuse for a securities professional to recommend and effect unsuitable margin trading in a customer's account.

At the hearing, the parties debated at length whether ME incurred gains or losses as a result of Hennion's trading, but that is irrelevant to the issue.[19] It would be as improper to excuse unsuitable recommendations that happened to result in gains as it would be to condemn suitable recommendations that resulted in losses.[20] The issue is whether Hennion adhered to his professional obligation under Rule 2310 to recommend and effect only transactions that were suitable for ME. For the reasons set forth above, the Hearing Panel finds that he did not; therefore, he violated Rule 2310, as charged.

The Complaint also charges that Hennion's trading in ME's account violated Rule 2510(a), which prohibits members and associated persons from effecting transactions in any discretionary account that are excessive in size or frequency in view of the financial

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[18] Cf. Department of Enforcement v. Stein, 2001 NASD Discip. LEXIS 38 ("Even if [the customer] understood the risks associated with margin trading and chose, notwithstanding the risks, to pursue it, we do not find that [the customer's] financial situation and investment objectives substantiated the increased risk to which Stein's margin trading exposed [the customer's] account").

[19] As explained above, the value of ME's account diminished somewhat during the period in question, and, in addition, she incurred substantial tax liability as a result of Hennion's trading. On the other hand, Respondents argue that her account out-performed the market during the period, and that over a somewhat longer period the value of the account actually increased by a substantial amount as a result of Hennion's recommendations and trades. There was no dispute that, to the extent that ME suffered losses, she recouped them as a result of an arbitration settlement with Respondents.

[20] Cf. Michael T. Studer, Exch. Act Rel. No. 50543, 2004 SEC LEXIS 2347 at *19 (Oct. 14, 2004): "An account may be churned even if the customer shows a profit on the excessive trading. To maintain otherwise would mean that 'securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested'" (footnote omitted). See also IM-2310-2(a)(2) ("sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers").

resources and character of the account. Hennion conceded that he exercised discretion in effecting at least some of the transactions in ME's account, but could not identify those transactions in which he did, or did not, exercise discretion. Hennion's inability to do so flows directly from his failure to comply with Rule 3010(b), as discussed below. Accordingly, the Panel finds that Hennion's discretionary trading in ME's account was excessive in size and frequency, and therefore violated Rule 2510(a), as well as Rule 2310. By violating Rules 2310 and 2510(a), Hennion also violated Rule 2110.

B. Exercising Discretion Without Written Authorization

The second cause of the Complaint charges that Hennion violated NASD Rule 2510(b), which prohibits any member or registered representative from exercising discretion in any customer's account unless the customer has given prior written authorization and the account has been accepted by the member, as evidenced in writing by the member or the person duly designated by the member in accordance with Rule 3010. Hennion conceded that he exercised discretion in ME's account with respect to at least some of the transactions at issue, and that he did not have prior written authorization from ME. Furthermore, it is undisputed that H&W never accepted the account in writing as a discretionary account. The Hearing Panel, therefore, finds that Hennion violated Rule 2510(b), as charged. By violating that Rule, he also violated Rule 2110.

C. Failure to Supervise

The third cause of the Complaint charges that Walsh violated NASD Rules 3010 and 2110 by failing to exercise reasonable supervision over Hennion in connection with

his trading in ME's account. Rule 3010(a) requires that NASD members "establish and maintain a system to supervise the activities of each registered representative … that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]." Rule 3010(a)(5) specifically requires "[t]he assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities." The SEC has explained:

> Final responsibility for supervision of the trading activities at a member firm of NASD rests with the firm's president, unless the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties. … The duty of supervision includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation.

Michael T. Studer, Exch. Act Rel. No. 50543, 2004 SEC LEXIS 2347 at *21-22 (Oct. 14, 2004) (footnotes omitted).

Walsh was H&W's president. Under H&W's written procedures, Hennion was responsible for supervising the firm's equities trading, while Walsh was responsible for supervising the firm's fixed income trading. No one, however, was designated as responsible for supervising Hennion's equities trading, as required by Rule 3010(a)(5). As a result, Walsh, by default, had that responsibility, but he did not fulfill it. Moreover, Walsh acknowledged that he was aware that Hennion was exercising discretion in ME's account, even though the firm had not authorized that in writing, and did not permit discretionary accounts. Although he was a principal and president of the firm, Walsh was not familiar with the relevant NASD rules, or the firm's written procedures relating to those rules. And although he claims he thought the firm's lone compliance person was

reviewing customer accounts, he did not know how that was accomplished, or take any steps to ensure that the compliance person was aware of and oversaw Hennion's discretionary trading in ME's account. He, himself, never questioned the suitability of any trades.

"A supervisor is responsible for 'reasonable supervision,' a standard that 'is determined based on the particular circumstances of each case.' … The SEC has held that '[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.'" Department of Enforcement v. VMR Capital Markets, No. C02020055, 2004 NASD Discip. LEXIS 18 (NAC Dec. 2, 2004). In this case, it is clear that Walsh failed to exercise reasonable supervision in the face of red flags that demanded inquiry into Hennion's trading in ME's account, and follow-up and review to ensure that Hennion's trading comported with NASD's rules on suitability and discretionary accounts. Instead, Walsh abdicated his responsibility to supervise. Therefore, the Hearing Panel finds that Walsh violated Rule 3010, and thereby Rule 2110, as charged.

D. Inadequate Supervisory Procedures

As explained above, Rule 3010(a) requires that member firms establish and maintain a supervisory system reasonably designed to achieve compliance with the securities laws and regulations and NASD rules, and specifically requires the assignment of each registered person to a supervisor. Rule 3010(b) requires that each member firm establish, maintain and enforce written procedures to supervise the types of business in which it engages.

H&W had no written supervisory procedures for discretionary accounts; indeed, the firm's written procedures prohibited such accounts. Nevertheless, Hennion, one owner of the firm, exercised discretion in ME's account, with the knowledge and acquiescence of Walsh, the other owner and the president of the firm, yet the firm failed to adopt procedures to fulfill the requirements of Rule 2510. Furthermore, H&W's written procedures failed to designate anyone to supervise Hennion's equity trading, and although they provided that customer accounts would be reviewed each month by a supervisor, they failed to designate any specific supervisor to carry out that review.

These failures were particularly serious because Rule 2510(b) requires that the member or a designated individual approve promptly, in writing, each discretionary order, and review each discretionary account at frequent intervals to detect and prevent transactions that are excessive in size or frequency. Although Hennion was exercising discretion in ME's account, H&W did not have written procedures in place designating someone to perform these functions and there is no evidence that, in fact, they were performed. The Panel finds, therefore, that H&W's written supervisory procedures failed to satisfy the requirements of Rule 3010.

IV. Sanctions

A. Unsuitable Transactions

For recommending unsuitable transactions, the Sanction Guidelines recommend that Adjudicators impose a fine of $2,500 to $75,000 and a suspension of 10 business days to one year, or in egregious cases a longer suspension of up to two years or a bar. NASD Sanction Guidelines at 97 (2004). The Guidelines for unsuitable transactions do not set out any specific considerations for Adjudicators, but the Sanction Guidelines

include general considerations to assist Adjudicators in arriving at sanctions for all types of violations, several of which apply here. Id. at 8-9.

Hennion's violation was serious, but not egregious. It involved only one customer, and the Panel credits his testimony that by trading stocks that he followed very closely, he intended to benefit ME.[21] Nevertheless, he traded speculative stocks on substantial margin in the account of a customer for whom such trading was patently unsuitable, putting her at great risk. Hennion acknowledged, in hindsight, that the highest margin balances in ME's account were too large, but overall he did not acknowledge that his trading was unsuitable. Instead, he sought to rationalize his actions, without recognizing that the factors he cites did not override his obligation to have reasonable grounds for believing that every transaction he recommended and effected for ME's account was suitable for her.

Therefore, for this violation, Hennion will be fined $25,000 and suspended in all capacities for four months. In addition, because Hennion does not appear to have a good grasp of his responsibilities as a registered person, he will be required to re-qualify in all capacities.

B. Exercising Discretion Without Written Authorization

For exercising discretion without written authorization, the recommend that Adjudicators impose a fine of $2,500 to $10,000 and in egregious cases consider suspending the respondent for 10 to 30 business days. In addition to the general considerations, these Guidelines direct Adjudicators to consider whether the customer's

[21] Hennion testified that most of H&W's customers are elderly and retired, like ME, and that his trading in ME's account was similar to that in a few of his other accounts, but there is no allegation or evidence that Hennion's trading in any of his other accounts was unsuitable.

grant of discretion was express or implied, and whether the firm's policies or procedures prohibited discretionary trading. Sanction Guidelines at 92 (2004).

Once again, the violation was serious, but not egregious. Hennion testified that ME expressly authorized him to exercise discretion when he could not reach her, and ME agreed. Hennion did not attempt to conceal that he was exercising discretion; Walsh knew Hennion was exercising discretion and did not object. But Hennion was aware that the firm's policies absolutely prohibited discretionary accounts, and should have known that, as a result, his discretionary trading was not receiving the oversight required under NASD discretionary account rules. The Hearing Panel, therefore, concludes that a $10,000 fine is an appropriate sanction for this violation.

C. Failure to Supervise

For failure to supervise, the Sanction Guidelines recommend that Adjudicators impose a fine of $5,000 to $50,000 and in egregious cases consider a suspension of up to two years or a bar. In addition to the general considerations, these Guidelines direct Adjudicators to consider whether the respondent ignored red flag warnings, the nature, extent, size and character of the underlying misconduct, and the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls. Sanction Guidelines at 105 (2004).

Walsh had clear red flag warnings. He knew ME's circumstances, knew that Hennion was exercising discretion in ME's account without ME's written authorization or the firm's written approval, and knew that Hennion was actively trading the account. He knew that he was not supervising Hennion's trading, and knew or should have known that no one else was, but took no steps to correct that deficiency. The unsuitable trading

that occurred was serious and continued for an extended period. Walsh failed either to implement the firm's procedures that prohibited discretionary accounts, or to cause the firm to adopt appropriate procedures to supervise such accounts. Finally, it was clear that Walsh does not understand his supervisory obligations as president of H&W.

Therefore, the Panel concludes that Walsh should be fined $25,000, suspended in all supervisory capacities for four months, and required to re-qualify in all principal capacities. Because Hennion and Walsh are H&W's owners, the Hearing Panel will schedule Walsh's suspension and re-qualification obligation to run consecutive, rather than concurrent, with Hennion's.

D. Inadequate Supervisory Procedures

For deficient written supervisory procedures, the Sanction Guidelines recommend that Adjudicators impose a fine of $1,000 to $25,000 and in egregious cases consider suspending the firm with respect to any or all relevant activities or functions for up to 30 business days and thereafter until the supervisory procedures are amended to conform to rule requirements. In addition to the general considerations, these Guidelines direct Adjudicators to consider whether the deficiencies allowed violative conduct to occur or escape detection, and whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance. Sanction Guidelines at 106 (2004).

In this case, the deficiencies in H&W's supervisory procedures allowed Hennion's discretionary trading in ME's account to continue without any effective oversight. Further, they made it impossible to determine who was responsible for supervising Hennion, or for reviewing customer accounts. Therefore, the Panel

concludes that H&W should be fined $10,000. Furthermore, because Respondents offered no evidence that H&W has corrected these deficiencies, the Panel will require that H&W retain, at its own expense, a consultant, acceptable to NASD staff, to review the firm's written policies and procedures, with particular attention to those found deficient in this proceeding, and recommend to H&W such amendments or additions as the consultant concludes may be required to ensure that the firm's written procedures comply with the securities laws and NASD rules.

E. Disgorgement of Financial Gain

In addition to other sanctions, the Sanction Guidelines for suitability violations, exercising discretion without written authorization and failure to supervise authorize Adjudicators to increase the amount of any fine by the amount of a respondent's financial benefit, and the general principles set forth in the Sanction Guidelines, which are applicable to all sanctions determinations, also advise that, where appropriate, Adjudicators should consider increasing a fine by the amount of the respondent's gain.

Therefore, the Panel concludes that it is appropriate to increase Respondents' fines to require them to disgorge their gain from the unsuitable trading in ME's account. At the hearing, the testimony established that the commissions paid by ME for Hennion's trading went entirely to the firm; Hennion and Walsh take no commissions for their trades, but rather, as the owners of the firm, take a salary and year-end bonuses based on the firm's overall performance. Under these circumstances, the Panel concludes that, rather than adding additional sums to the fines separately imposed on each of the Respondents for their individual violations, it is appropriate to impose an additional joint and several fine on all three Respondents in the amount of $40,000.

V. Conclusion

Respondent Richard Hennion made unsuitable recommendations to a customer, in violation of Rules 2310, 2510(a) and 2110, and IM-2310-2, and exercised discretion in the customer's account without written authorization, in violation of Rules 2510(b) and 2110. For these violations, he is suspended in all capacities for four months and fined a total of $35,000. He is also required to re-qualify in all capacities after his suspension begins and prior to resuming any activities requiring registration.

Respondent William W. Walsh failed to exercise reasonable supervision over Hennion, in violation of Rules 3010 and 2110. For that violation, he is suspended in all supervisory capacities for four months and fined $25,000. He is also required to re-qualify in all principal capacities after his suspension begins and prior to resuming any activities requiring registration as a principal.

Respondent Hennion & Walsh, Inc. failed to have reasonable supervisory systems and procedures, in violation of Rules 3010 and 2110. For that violation, it is fined $10,000 and ordered to retain an independent consultant, approved by NASD District 9 staff, to review its written policies and procedures, with particular attention to those found deficient in this proceeding, and to prepare and submit to District 9 a report setting forth the consultant's recommendations and the firm's actions to implement those recommendations.

In addition, for their violations Respondents, jointly and severally, are fined $40,000 and are ordered to pay costs in the amount of $3,789.97, which includes an administrative fee of $750 and hearing transcript costs of $3,039.97.

These sanctions shall become effective on dates set by NASD, but not earlier than 30 days after this decision becomes NASD's final disciplinary action in this matter, except that if this decision becomes NASD's final disciplinary action, Hennion's suspension shall begin on March 7, 2005, with the opening of the business day and end on July 6, 2005, at the close of the business day, and Walsh's suspension shall begin on July 18, 2005, with the opening of the business day and end on November 17, 2005, at the close of the business day.[22]

HEARING PANEL

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By: David M. FitzGerald
Hearing Officer

Copies to:
Hennion & Walsh, Inc. (*via overnight and first class mail*)
Richard Hennion (*via overnight and first class mail*)
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Daniel J. Reiser, Esq. (*via facsimile and first class mail*)
David B. Klafter, Esq. (*electronically and via first class mail*)
Rory C. Flynn, Esq. *(electronically and via first class mail)*

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