NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RESPONDENT 1 and MICHAEL BLAISE DOHERTY (CRD No. 1325333), Respondents.	Disciplinary Proceeding No. C9B040036 Hearing Officer – SNB **HEARING PANEL DECISION** March 15, 2005

Complainant failed to prove by a preponderance of the evidence that Respondent 1 lacked reasonable grounds for believing that his investment recommendations were suitable for a customer as required by NASD Conduct Rules 2310 and 2110, and, accordingly, that charge is dismissed.

Respondent Doherty failed to reasonably supervise Respondent 1's trading activities in violation of NASD Conduct Rules 3010 and 2110. For that violation he is suspended in all supervisory capacities for 10 business days and fined $5,000.

Appearances

Lynn M. Kaseta, Esq. and Michael Newman, Esq., Woodbridge, NJ (Rory C. Respondent 1, Esq., Washington, DC, of Counsel), for Complainant.

Frank J. Cuccio, Esq., and Matthew C. Plant, Esq., New York, NY, for Respondents.

DECISION

I. Procedural History

On May 4, 2004, the Department of Enforcement filed a Complaint charging that Respondent 1 made unsuitable recommendations to one customer in violation of NASD Conduct Rules 2110, 2310, and IM-2310-2, by recommending that the customer purchase Class B shares in mutual funds in different fund families, rather than Class A shares in one fund family. In addition, the Complaint charged that Michael Blaise Doherty ("Doherty") failed to reasonably supervise Respondent 1 in violation of NASD Conduct Rules 3010 and 2110. Respondent 1 and Doherty filed an Answer denying the charges and requesting a hearing. The Hearing was held in Woodbridge, New Jersey on October 6, 7 and 8, 2004, before a Hearing Panel that included a Hearing Officer and two Panelists.[1]

II. <u>Cause One: Suitability (Respondent 1)</u>

A. <u>Facts</u>

Respondent 1 became registered with the NASD as a General Securities Representative in l987 and as a General Securities Sales Supervisor in 1996. Respondent 1 was registered with Chase Investment Services, Corp. ("Chase") on March 30, 1993 and he continues to be so registered. He is therefore subject to NASD's jurisdiction. Respondent 1 has no prior disciplinary history.[2]

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[1] One Panelist was a current member of the District 7 Committee, and the other Panelist was a former member of the NASD Board of Governors and the District 10 Committee. Enforcement offered Complainant's Exhibits ("CX") 1 and 3-25, which were admitted without objection. Respondents offered Exhibits ("RX") 1-23 (RX-23; pp. 1-28 and 49-55), 24-34, and 36-46, which were admitted without objection. References to the Hearing transcript are cited as "Tr. at p." References to the Stipulations of the parties are cited as "Stip. at paragraph."

[2] Stip. at paragraph 2; CX-2.

Customer KH was a Mechanical Engineer holding a managerial position with his employer until he retired in February 2001 at the age of 61.[3] In July 2000, KH opened an account with Chase.[4] KH's account was transferred to Respondent 1 in October 2000, when Larry Kaplow ("Kaplow"), KH's previous financial advisor, left the firm.[5]

On October 24, 2000, Respondent 1 and KH spoke for the first time.[6] Respondent 1 and KH reviewed a retirement plan and an asset allocation analysis that Kaplow previously prepared for KH.[7] KH confirmed that the information in these materials, including the net worth statement, was still accurate. In particular, KH confirmed that he had over $850,000 in retirement assets (principally consisting of two employer retirement plans with Prudential ("Employer Plans")) and approximately $650,000 in non-retirement assets, including equities, Class B mutual funds[8] and approximately $300,000 cash.[9] In addition, KH indicated to Respondent 1 that he had decided to take a retirement package from his employer, but he was still working there four days a week. KH said that he would get a $100,000 cash payout upon retirement.[10] KH also indicated that his Employer Plans were "off the table" – he was not interested in

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[3] Tr. at p. 30-31.

[4] CX-11.

[5] Tr. at p. 37, 362, 575, 599.

[6] On this and several other points, KH's testimony conflicted with that of Kaplow and Respondent 1. For reasons explained below, on the points in dispute the Hearing Panel found that Kaplow's and Respondent 1's testimony was more credible than KH's. (Tr. at p. 362)

[7] CX-6; CX-7. With respect to the Asset Allocation Plan, although KH had indicated in his earlier discussion with Kaplow that he wanted a 70% equity, 30% fixed income allocation of assets, after further discussing the allocation with Respondent 1, he adjusted this to a 65% equity, 35% fixed income mix. (Tr. at p. 390)

[8] KH's holdings included Class B shares of Eaton Vance, Dreyfus, and Morgan Stanley Dean Witter funds, as well as Van Kampen Class C shares. (Tr. at p. 78-82)

[9] CX-6 at p. 3.

[10] CX-10, RX-23 at p. 14; Tr. at p. 366-368.

rolling them over to a Chase account.[11] KH made a number of notes on the materials Respondent 1 reviewed with him.[12]

Respondent 1 also reviewed KH's account opening documentation, in which KH indicated that his investment objective was income and capital appreciation; his risk tolerance was moderate; and his investment knowledge was "good," with over thirty years of investment experience, specific investment knowledge in stocks, mutual funds, and commodities, and an investment time horizon of over ten years.[13]

KH asked Respondent 1 to look at his non-retirement assets and make a recommendation as to whether to hold or sell the equities and funds, how much to keep in cash and how much to invest.[14] Consistent with KH's request, in early November 2000, Respondent 1 met with KH at his house and presented to KH a document entitled "Investment Recommendation and Income Projection" ("Investment Recommendation"). The Investment Recommendation reflected information that KH provided to Respondent 1 at their meeting the week before regarding each of KH's assets, and made a recommendation as to whether to sell or hold these assets. It also made assumptions as to KH's retirement income needs and reflected the asset allocations decided upon in their earlier meeting.[15]

Respondent 1 recommended that KH continue to hold his individual security investments, and his Dreyfus, Van Kampen, and Morgan Stanley mutual fund investments, which had been performing well, but that he sell his Neuberger Berman

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[11] Tr. at p. 374, 488.

[12] CX-6, CX-7, CX-8; Tr. at 49-50, 374-375, 411.

[13] CX-11 at p. 2, 11, 13; Tr. at 434-441, 589-593.

[14] CX-10, RX-23 at p. 14; Tr. at p. 373.

[15] CX-8; Tr. at 49-50, 411.

Fund because it had underperformed in its market category in the last six or seven years. Respondent 1 also recommended that KH hold his CD to maturity and hold his investments in individual securities.[16]

The Investment Recommendation reflected that in retirement, KH would need to generate income from his investments. In order to do this, Respondent 1 recommended that KH maintain $100,000 of his cash to cover the first year's expenses, and invest his remaining $360,000 in cash assets in six mutual funds.[17] Respondent 1 estimated that starting the second year, KH would need to make systematic withdrawals from his mutual funds.[18]

The Investment Recommendation also noted that KH had retirement ("qualified") assets valued at approximately $870,000 at that time. KH again confirmed that he was happy with his Employer Plans with Prudential, and that these assets were "off the table" for discussion.[19]

Respondent 1 and KH discussed an investment in mutual fund shares consistent with the selected asset allocation. In that regard, Respondent 1 recommended that KH invest $360,000 of his cash assets in Class B shares of six mutual funds: the Davis NY Venture Fund, the AIM Value Fund, the Vista Small Cap Opportunities Fund, the Delaware Sector Growth Fund, the Rochester Municipal Bond Fund, and the Pimco Total Return Fund. Respondent 1 and KH reviewed the Morningstar reports on these funds, and discussed each of the fund's objectives in order to achieve diversification consistent

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[16] Tr. at p. 414-418.

[17] CX-8. This $360,000 included approximately $166,000 in proceeds from the sale of the Neuberger Berman fund. RX-26 at p. 11.

[18] CX-8; Tr. at 407-410, 418.

[19] CX-8; Tr. at p. 425, 426, 488-489.

with KH's Asset Allocation Analysis.[20] They also reviewed the performance history of each fund. Respondent 1 and KH generally discussed the differences between mutual fund share classes. Respondent 1 gave KH copies of the prospectuses of the funds, and showed him printouts reflecting breakpoints available for Class A shares.[21] KH already owned Class B mutual funds in other accounts, and said that he wanted to avoid paying a front-end charge.[22]

Broker-sold mutual funds generally offer more than one class of shares. Each class has the same investment portfolio, but differs as to front-end or back-end sales loads, on-going charges to pay for sales and marketing expenses (referred to as "Rule 12b-1" fees), and contingent deferred sales charges ("CDSC") if funds are sold before a specified time.

For example, Class A shares may charge a front-end load, which is taken out of the sales price before the investment goes into the fund, but may offer a lower Rule 12b-1 fee. If the investment in Class A shares in a single fund family is large, an investor may receive a discount on the front-end load. The levels at which the discounts become available are called breakpoints. Breakpoints can be attained either in a single purchase

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[20] Tr. at p. 420-433. A number of Morningstar reports were attached to CX-6, the Asset Allocation Analysis. These reports may have been attached when Kaplow presented the report to KH in March 2000. However, it is undisputed that they were attached when Respondent 1 reviewed the Analysis with KH in October and November 2000. The reports included Morningstar reports, or in one case, a fact sheet, for: the Davis New York Venture Fund (Morningstar four star rating); the AIM Value Fund (Morningstar five star rating); the Putnam Growth Opportunities fund (Morningstar five star rating); the Chase Vista Small Cap Opportunities Fund (fact sheet from Fund); the Delaware Select Growth fund (Morningstar five star rating); the Munder NetNet fund (Morningstar five star rating); and the Janus Worldwide fund (no load; Morningstar five star rated); as well as Morningstar reports for the funds that KH already owned. (Tr. at p. 86, 615-616)

[21] RX-30; Tr. at p. 428-430.

[22] CX-8, CX-7; Tr. at p. 421, 445, 457, 490.

or over a period of months pursuant to a letter of intent[23] or rights of accumulation.[24] However, breakpoints on Class A share front-end loads are only available for investments in the same fund family. An investor does not incur a CDSC when class A shares are sold.

In contrast, Class B shares generally do not charge a front-end load. Instead, they generally charge higher ongoing 12b-1 fees, and they generally impose a back-end sales load in the form of a CDSC when an investor sells the shares before the end of a designated period. The CDSC generally declines over time, and is eliminated after six to eight years and the CDSC is generally inapplicable to certain planned systematic withdrawals, as provided in the fund's prospectus. Class C shares may impose neither a front-end nor a back-end sales load, but may instead impose a higher 12b-1 fee.

In recommending Class B shares, Respondent 1 took into account KH's desire to avoid front-end loads. Moreover, he considered that, for the proposed investment of approximately $360,000, the front-end load would amount to over $10,000, assuming KH were able to obtain a 1 percent breakpoint by investing the entire $360,000 in Class A shares of a single fund family. Respondent 1 also considered the higher 12b-1 fees that KH would incur by investing in Class B shares over seven years (after which, the B shares would generally convert to Class A shares), but believed that the benefit from diversifying among several top-performing funds from different fund families outweighed the savings that would have been available if KH invested in Class A shares of less desirable funds in one fund family. In that regard, Respondent 1 believed, based

[23] A letter of intent is a statement signed by the investor indicating his or her intent to purchase a certain amount of fund shares over a stated period.

[24] A right of accumulation is the discount or breakpoint received in a current mutual fund transaction based upon the cumulative value of previous transactions.

on his experience, that any one fund family would not likely have funds that were strong in every category, and therefore that diversification among fund families would allow KH to invest in funds that had strong performance records. He also considered that CDSC's would not be charged for KH's planned systematic withdrawals as set forth in the Investment Analysis. Finally, Respondent 1 reasoned that by investing in funds from several fund families, KH preserved the option, in the event that rebalancing of his portfolio became necessary, to switch to other funds within those various fund families without any charge. Based on all these considerations, Respondent 1 recommended that KH invest in Class B shares in a variety of mutual funds with strong historic performance records in several different fund families, rather than in Class A shares of funds within a single fund family.[25]

KH followed Respondent 1's recommendation, and on November 9, 2000, KH purchased approximately $5,825 in the AIM Value Fund; $90,000 in the Davis NY Venture Fund; $72,825 in the Pimco Total Return Fund; $97,100 in the Rochester Municipals Fund; $48,550 in the Chase Vista Small Cap Opportunities Fund; and $48,550 in the Delaware Select Growth Fund. He purchased an additional $5,225 in the Davis NY Venture Fund on November 10, 2000. All of these were Class B shares.[26]

KH retired in February 2001. He received approximately $100,000 from his employer, which he deposited into his account with Respondent 1 at Chase. In March 2001, KH purchased approximately $30,650 of Pimco Total Return Class B shares, and approximately $67,650 in the Rochester Municipal Class B shares. Respondent 1 recommended these purchases based on KH's request for a more conservative, fixed

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[25] Tr. at p. 390-422.

[26] Stip. at Schedule A; Tr. at p. 410-435

income investment for these funds. Respondent 1 recommended the purchase of B shares for essentially the same reasons he recommended the prior purchases.[27]

In April 2001, Respondent 1 met with KH to discuss his account. Respondent 1 took notes of this meeting.[28] They discussed KH's non-retirement cash and securities assets held outside of his accounts at Chase, including $60,000 at Summit Financial and $147,000 at PNC, and additional investments at Dean Witter, which included other mutual fund Class B shares and individual equities. KH transferred these remaining non-qualified assets to Respondent 1 at Chase. They did not discuss a rollover of KH's Employer Plans at this time.[29]

In May 2001, the value of KH's Employer Plans at Prudential had dropped from approximately $850,000 to approximately $650,000. KH was dissatisfied with his former employer and the performance of these plans, and determined to roll the plans over into a Chase account. Several weeks later, at Respondent 1's recommendation, KH purchased $65,000 in the Aim Value Fund; $97,500 in the Alliance Growth and Income Fund; $55,000 in the Fidelity Advisor Mid Cap Fund; $61,000 in the Liberty Acorn Fund; $65,000 in the MFS Mass Investor Growth Stock Fund; $65,000 in the Pimco Total Return Fund; $97,000 in the Pimco Real Return Bond Fund; $97,000 in the Scudder Dreman High Return Fund; $20,000 in the JP Morgan Dynamic Small Cap Fund; and $27,000 in the Delaware Select Growth Fund. All of these were Class B shares, and, once again, Respondent 1 recommended them based on the same type of analysis that led

[27] Stip. at Schedule A; Tr. at p. 53-56, 442-445.

[28] RX-23 at p. 28.

[29] RX-28 at p. 2, 11, 13; Tr. at p. 446-450.

him initially to recommend that KH invest in Class B shares of funds from several fund families rather than Class A shares of funds from a single family.[30]

In the summer of 2001, KH attended a number of free investment seminars sponsored by other brokerage firms. At one of these seminars, a representative of another brokerage firm looked at KH's account and said that he should not have been invested in Class B shares, and that Respondent 1's recommendations were "criminal." From these seminars, KH had the mistaken impression that if he had invested in Class A shares, he would have gotten more shares for less money. This upset KH, and he called Respondent 1 for an explanation. Respondent 1 responded to KH's inquiry, but KH was unsatisfied, and he wrote Respondent 1 a complaint letter on September 24, 2001, a time when the market had suffered a dramatic decline following the September 11, 2001 tragedy. Respondent 1 disclosed the letter to Chase and from that point on, communications between Respondent 1 and KH ceased as Chase investigated KH's complaint. As of the Hearing, KH continued to hold the investments originally recommended by Respondent 1.[31]

Enforcement argued that Respondent 1's recommendations were unsuitable because KH's costs would have been lower if he had invested in Class A shares of a single fund family rather than the Class B shares in several fund families that Respondent 1 recommended. In support, Enforcement relied on an analysis ("Enforcement's Analysis") prepared by its investigator.

Enforcement's Analysis assumed a hypothetical investment by KH in Class A shares of several funds in the Alliance Fund family. Enforcement selected the Alliance

[30] Stip. at Schedule A, Stip. at paragraph 8; RX-27 at p. 31; Tr. at p. 453-558.

[31] CX-4; Tr. at p. 57-64, 464-465.

Fund family because it had a large number of funds. For its analysis, Enforcement selected funds that, based upon fund names and objectives, it believed were comparable to the funds that Respondent 1 recommended and in which KH actually invested.

Enforcement's Analysis assumed that, if KH invested in Class A shares of Alliance funds, his first investment of approximately $360,000 in November 2000 would have benefited from a $250,000 breakpoint, reducing the front-end load to two percent. Enforcement's Analysis used a six-year timeframe, as after that point the Class B shares that Respondent 1 recommended would convert to Class A shares, and KH would no longer incur higher 12b-1 fees by holding them or be required to pay a CDSC upon their sale.

Similarly, for the second investment of approximately $100,000 in March 2001, Enforcement's Analysis assumed that KH continued to invest in Class A shares in the Alliance family, and thereby continued to benefit from the $250,000 breakpoint under rights of accumulation. Finally, for the third investment of approximately $650,000 in June 2001, Enforcement's Analysis assumed that KH continued to invest in Class A shares in the Alliance family and the account benefited from a $1 million breakpoint.[32]

Based on these assumptions, Enforcement's Analysis concluded that KH would have saved approximately $4,700 in costs for the November transaction and $1,900 in costs for the March transaction over a six-year period by buying Class A shares, taking into account the breakpoint that would have been available under rights of accumulation for investments in a single fund family. Moreover, KH would have saved $18,980 in costs for the June transaction over the same six-year period, taking into account the

[32] CX-25; Tr. at p. 195-223, 255-257.

breakpoint available for $500,000 or more invested in Class A shares in the same fund family.[33] In addition, Enforcement's Analysis showed that Respondent 1 and Chase would have received substantially lower commissions.[34]

Enforcement's Analysis focused exclusively on the cost savings KH would have enjoyed if he had purchased Class A shares in a single fund family – it did not consider actual or potential performance differences between the funds that Respondent 1 recommended and the Alliance family funds that Enforcement proposed as a better alternative.

In contrast, Respondent 1 offered an analysis prepared by Peter Wall, the Chief Investment Officer for J.P. Morgan Chase's Division of Personal Financial Services, (the "Wall Analysis") that considered overall investment performance, as well as costs. The Wall Analysis made adjustments to the portfolio of funds in the Alliance Fund Family used in Enforcement's Analysis to better correlate to the funds recommended by Respondent 1, based upon correlation coefficients provided by Morningstar. Enforcement did not dispute Wall's assessment on the selection of more comparable funds, and the Panel agreed that the selections in the Wall Analysis provided a better basis for comparison than those in Enforcement's Analysis.[35]

The Wall Analysis compared the performance of the revised portfolio of Alliance Fund investments to KH's actual investments recommended by Respondent 1. The Wall

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[33] The analysis also shows that KH would have saved $42,000 in costs if a $1 million breakpoint was available. However, for reasons set forth herein, the Panel rejected the assumption required to establish the availability of a $1 million breakpoint.

[34] According to Enforcement's Analysis, Chase would have received $7,261.50 if KH had purchased Class A shares, as compared with $14,723.00 in commissions that Chase actually received for the Class B shares that Respondent 1 recommended and KH purchased.

[35] RX-44; Tr. at p. 306-324, 337-339.

Analysis took into account the front-end loads and breakpoints that KH would have received by investing in Alliance Class A shares, and the relatively higher 12b-1 fees that were charged on the Class B shares that KH actually purchased. The Wall Analysis then compared the actual performance of these alternative portfolios through August 31, 2004, and found that the Class B shares that KH actually purchased outperformed the Alliance Fund hypothetical portfolio by $20,025. Similarly, KH's actual portfolio showed a cumulative return of 5%, as compared with a cumulative return of 3.2% for the Alliance Fund portfolio.[36]

B. <u>Discussion</u>

NASD Conduct Rule 2310(a) provides that, in recommending a purchase of a security to a customer, a broker "shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." "[S]ales 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."[37] There is

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[36] The Wall Analysis also considered the alternative scenario urged by Enforcement, which assumed that KH expressed his intent to invest all $1.1 million with Chase from the outset (which the Hearing Panel found he did not do). This would have allowed him to use letters of intent to avoid any sales charges for his Alliance Class A share purchases. The Wall Analysis showed that, even under these circumstances, KH's actual portfolio outperformed Enforcement's hypothetical portfolio by $8,573, with a cumulative return of 5% as compared with a cumulative return of 4.2% for the Alliance portfolio. (RX-44 at p. 1, 2, 12; Tr. at p. 325-336)

On cross-examination Enforcement established that the calculations in the Wall Analysis did not take into account the CDSC that would have been assessed if KH had sold his Class B shares. However, there was no credible evidence in the record that KH intended to sell his Class B shares; indeed, Respondent 1's recommendation was in part premised on an analysis concluding that KH could obtain the funds he needed through systematic fund withdrawals that would not trigger CDSC's. (RX-2 at p. 16; Tr. at p. 342-345, 536-542)

[37] IM-2310-2(a)(2).

no dispute that Respondent 1 recommended the investments in question to KH – the issue is whether he had a reasonable basis for those recommendations.

In the case of mutual funds, prior to the events underlying this case, NASD had repeatedly reminded its members "to consider all of the expenses charged, and discounts offered, by a mutual fund in determining whether the purchase of that fund's shares is suitable."[38] Moreover, just prior to the transactions in question, NASD issued a release specifically directing its members to consider the suitability of recommending large investments in Class B shares, especially for long term investments, with particular attention to the fact that lower sales charges and discounts are frequently available to the purchasers of Class A shares of a mutual fund due to the availability of breakpoints, rights of accumulation, or letters of intent.[39] NASD's Notices did not, however, suggest that Class B shares were per se unsuitable, or that registered representatives were required in all cases to recommend funds from a single family without regard to other factors.

Enforcement argued that Respondent 1 lacked a reasonable basis for believing that it was suitable for KH to purchase Class B shares in mutual funds totaling over $1.1 million because if KH had instead purchased Class A shares in a single fund family, he would have enjoyed substantial cost savings, and would have paid substantially lower commissions.

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[38] Wendell D. Belden, Exchange Act Release No. 47,859, 2003 SEC LEXIS 1154, at *13 (May 14, 2003) (citing to NASD Notice to Members 95-80 (Sept. 1995)); *See* NASD Notice to Members 94-16 (Mar. 1994).

[39] Suitability Issues for Multi-Class Mutual Funds, NASD REGULATORY AND COMPLIANCE ALERT (Summer 2000).

Respondent 1 offered a detailed explanation of the reasoning that led him to conclude that his recommendations were suitable. In particular, he stated that he considered the additional costs of the Class B shares he recommended compared to an investment in Class A shares from a single fund family, but believed those costs were outweighed by the value of diversifying KH's investment among top-performing funds from several different families. With regard to the comparative costs, Respondent 1 testified that until May 2001, KH had indicated that he did not intend to rollover his Employer Plans into a Chase account, and therefore Respondent 1 did not consider the possibility that KH might be able to utilize those funds, in addition to the other funds he intended to invest through Chase, to obtain breakpoints if he invested in Class A shares. In contrast, KH testified that Respondent 1 knew when he made his initial recommendations that KH contemplated rolling over his Employer Plans to Chase. This dispute is important because Respondent 1 acknowledged that if he had known that KH intended to rollover his Employer Plans to Chase and KH would retire within a short timeframe, his recommendations would probably have been different.[40]

As noted above, however, the Hearing Panel found Respondent 1's testimony more credible than KH's, based on internal inconsistencies in KH's testimony and conflicts between KH's testimony and record evidence. For example, KH emphatically claimed that he first spoke with Respondent 1 before June 2000 and he gave detailed testimony about conversations with Respondent 1 as to whether he should agree to take an early retirement package (which KH actually accepted in June 2000). KH further testified that his first conversation took place while Respondent 1 was in the Morristown

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[40] Tr. at p. 487-489.

office and after Kaplow left Chase.[41] However, in direct conflict, the record evidence reflects that KH signed a letter addressed to Kaplow in August 2000 to transfer certain securities holdings.[42] Moreover, it is undisputed that Kaplow did not leave Chase until October 2000, and Kaplow testified that he would not have introduced KH to Respondent 1 until shortly before he left. It is also undisputed that Respondent 1 was not in the Morristown office until August 2000.[43] Finally, Respondent 1's contemporaneous notes of his first meeting with KH, which were dated October 24, 2000, further support the version of events offered by Kaplow and Respondent 1. For these reasons, the Panel found that KH's first contact with Respondent 1 was in October 2000, not earlier as KH testified.[44]

In addition, the Panel did not find credible KH's continuing theme, both in his prior sworn written statement and in his testimony, that he was an inexperienced, malleable investor who would do whatever Respondent 1 said.[45] For example, KH claimed that he had minimal investment experience. In his sworn written statement KH said he never had a financial advisor prior to Chase. He maintained this story, even when confronted with account statements from three different brokerage firms dated before he opened his Chase accounts indicating the name of KH's financial advisors at

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[41] Tr. at p. 37, 40, 124, 125.

[42] RX-24 at p. 38; Tr. p. at 126, 127.

[43] Tr. at p. 37, 351, 598-600. In its closing argument, Enforcement asserted that Kaplow's testimony that he had offices in both Morristown and New York beginning in May 2000 was consistent with KH's claim that he spoke with Respondent 1 in Morristown before June 2000, rather than October 2000 as Respondent 1 and Kaplow testified. The Panel found that the mere fact that Kaplow also had an office in New York was insufficient to support Enforcement's theory, particularly given Kaplow's testimony referenced above, and Enforcement's failure to discredit Respondent 1's testimony that he did not maintain a Morristown office until August 2000 (something Enforcement should have been able to disprove with Chase records if Respondent 1's testimony was not accurate).

[44] RX-23 at p. 14; Tr. at p. 37, 41-42, 45, 351, 362, 575-576, 598-600.

[45] CX-5 at p. 3, paragraph 8; Tr. at p. 31-32, 52, 97, 99-100.

those firms. Moreover, KH later testified that he purchased his individual equities prior to opening his Chase accounts through different financial advisors or "brokers," – without appearing to recognize or acknowledge that this was inconsistent with his earlier testimony that he had never had a financial advisor before opening his Chase accounts.[46] Moreover, KH's account opening statement at Chase, which indicated that he had 30 years of investment experience in stocks, mutual funds and commodities, also undercut KH's claim of minimal experience and no contact with a financial advisor prior to Chase. In fact, contrary to KH's assertion that he would do anything Respondent 1 suggested, KH rejected Respondent 1's recommendation of an international fund (which happened to be a no-load fund).[47] The Panel also credited Kaplow's testimony that KH was a skeptical person with whom it took a long time to build up trust.[48]

Because the Hearing Panel found KH's testimony not to be credible, it did not credit KH's claim that when Respondent 1 made his earlier recommendations, he knew that KH would be rolling over his Employer Plan to Chase upon retirement. Instead, the Panel credited Respondent 1's testimony that KH said he was happy with the existing investment of his qualified assets in his Employer Plans, and that he did not intend to move them to Chase.

The Hearing Panel found that, based upon the information that KH provided concerning the various factors set forth in Rule 2310, Respondent 1's testimony, unless rebutted, was sufficient to show that he had a reasonable basis for believing that his recommendations were suitable for KH. According to Respondent 1, he considered the

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[46] CX-5 at p. 2, paragraph 2; Tr. at p. 77-83, 590, 591.

[47] Tr. at p. 105.

[48] Tr. at p. 458, 579.

comparative costs, but concluded that other factors outweighed the cost savings from investing in Class A shares in a single fund family, and he explained his assessment of those factors in detail. In particular, Respondent 1 testified that in making his recommendations, he took into account the performance history of each fund, the benefits of diversification among fund families, the use of systematic withdrawals to avoid CDSC's, and the ability to make cost-free adjustments in the future should KH determine that he would like to switch to another fund within the range of fund families in which he invested. Respondent 1 testified that, having considered these factors, he concluded that his recommendation would best serve KH's interests.

Enforcement made no effort to challenge the premises underlying Respondent 1's multi-factor analysis. Instead, Enforcement argued that cost alone is the controlling factor in determining whether Respondent 1 had a reasonable basis for believing his recommendations were suitable for KH.

The Panel, however, rejects the notion that Respondent 1 was, in essence, required to formulate his recommendation based on a single factor – costs. Tailoring recommendations for individual investors requires more than a mechanical comparison of costs; in making a recommendation, a registered representative must take into account a variety of factors that bear upon whether a particular investment is suitable for a specific investor. Ultimately, a recommendation must be based on a careful balancing of the overall potential rewards and risks of a potential investment.

The Wall Analysis shows why this is the case. By following Respondent 1's advice, KH made $20,025 more than he would have made had he invested in the Alliance fund family as proposed by Enforcement's Analysis that was based solely on cost

savings. Of course, this does not establish that Respondent 1's recommendations were suitable any more than a lower return would have established they were unsuitable. Suitability determinations must be based on the information available at the time of the recommendation, not the actual performance of the recommended investment. But the gains that KH has enjoyed by following Respondent 1's advice show why a suitability analysis must be more comprehensive than Enforcement acknowledges.

The Hearing Panel, therefore, finds that Enforcement failed to prove by a preponderance of the evidence that Respondent 1 lacked a reasonable basis for believing that his recommendations were suitable. In reaching that conclusion, the Panel does not mean to endorse Respondent 1's recommendations. The Panel merely holds that, once Respondent 1 articulated reasonable grounds for his recommendations, "it [was] then up to Enforcement to discredit those grounds with its own evidence and on cross-examination, such that the preponderance of evidence shows that the [recommendations were] not based on reasonable grounds." Department of Enforcement v. Respondent, No. C07010037, 2003 NASD Discip. LEXIS 16, at *24 (May 13, 2003). Enforcement, focusing exclusively on costs, failed to discredit the grounds cited by Respondent 1 for his recommendations.[49] Accordingly, the charge that Respondent 1 violated Rule 2310, and thereby also violated Rule 2110, is dismissed.

III. Cause Two: Failure to Supervise (Doherty)

A. Facts

[49] This case is distinguishable from two recent NASD decisions, because in those cases, the Respondents' recommendations were for the stated purpose of generating commissions. Department of Enforcement v. Sathianathan, No. C9B030076, (NASD Office of Hearing Officers, November 30, 2004) at p. 34, http://www.nasd.com/web/groups/enforcement/documents/oho_disciplinary_decisions/nasdw_013075.pdf, appeal pending, and Department of Enforcement v. Belden, No. C05010012; 2002 NASD Discip. LEXIS 12, at *10-11 (NAC August 13, 2002).

Doherty became registered with the NASD as a General Securities Representative in l984 and as a General Securities Principal in 1997. Doherty was registered with Chase in 1996 and he continues to be so registered. He is therefore subject to NASD's jurisdiction. Doherty has no prior disciplinary history.[50]

Doherty began to supervise Respondent 1 in August 2000. As of that time, NASD had issued several Notices on the subject of suitability issues for mutual funds.[51] These Notices emphasized the importance of ensuring that mutual fund recommendations are suitable, particularly where they involve large purchases of Class B shares. Consistent with the NASD's pronouncements, Chase had written procedures designed to detect suitability issues with respect to mutual fund investments.

As part of these procedures, Doherty was required to review the Daily Transaction Blotters ("Blotters") on a bi-weekly basis for, among other things, any suitability issues.[52] With respect to KH's June 2001 $650,000 investment, while Doherty evidenced his review by initialing the Blotters, the required dollar amounts were not included.[53]

During his on-the-record testimony ("OTR") in connection with the NASD staff's investigation, Doherty testified that twice a month his assistant would print hard copies of the Blotters, and that he would review them with her. When confronted with the Blotters for KH's June transactions, on which no principal amounts were included, Doherty said he was concerned that he could not see the principal amount of the trade and did not

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[50] Stip. at paragraph 2; CX-3; Tr. at p. 545-547.

[51] *See supra* notes 38 and 39 and accompanying text.

[52] CX-18 at p. 2-3.

[53] CX-15, CX-16, CX-18 at p. 3-4; Tr. at p. 189-193, 550-553.

know how he conducted his review.[54]

Chase also had procedures requiring a manager's written pre-approval for any investment totaling over $500,000. In connection with that approval, the manager was instructed to review the transaction as to suitability, diversification and charges, among other things. The manager was also required to complete and sign an "Investment Manager Investment Pre-Approval Form."[55]

Accordingly, Doherty was also required to pre-approve KH's June 2000 investment of $650,000. Doherty's signature does appear on such a pre-approval form that is dated just prior to the $650,000 investment. However, the form is incomplete, because it does not include such required and essential information as the actual products to be purchased, the share classes and the purchase amounts. Moreover, a field requiring an explanation of the suitability of the investments is left blank.[56]

Doherty's testimony at his OTR and his written response to the NASD during the investigation was that he recalled meeting KH, but did not recall what was discussed. However, he maintained that he had all the information that he needed to approve the

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[54] CX-22 at p. 30, 85-87. During the Hearing, Doherty claimed that he reviewed the Blotters electronically (rather than in hard copy), and following his review of the Blotters, he would print and sign them. He testified that the electronic display included the product purchased and the shares and dollar amounts. Doherty testified that Respondent 1's office was right next to his, so if he had any questions during a review of Respondent 1's Blotters, he would call Respondent 1 into his office and discuss them. (Tr. at p. 552-567, 670-673)

Doherty explained the discrepancies between his Hearing testimony and his OTR testimony, saying he was uncomfortable and nervous at the OTR, and he was overly narrow in his focus when he gave an answer. (CX-22 at p. 18, 19, 34, 68, 69, 83-85; Tr. at p. 563, 676) But despite these discrepancies and Doherty's position that his OTR testimony was in error, he did not subsequently attempt to correct the record, and he did not include a clarification in his Wells submission. Rather, he waited until the Hearing to offer this revised version of events. (Tr. at p. 687-689) The Panel credited Doherty's account during his OTR, rather than his testimony at the Hearing.

[55] CX-13 at p. 12, 46; Tr. at p. 181-184, 358-360, 545-546.

[56] CX-16 at p. 86, CX-18 at p. 4, CX-20; Tr. at p. 182-192, 549, 662-664.

transaction.[57] During the Hearing, Doherty expressed the view that completion of the form was optional.[58]

B. Discussion

Enforcement alleged that Doherty violated NASD Conduct Rule 3010 by failing to reasonably supervise Respondent 1's trading activities in KH's accounts. NASD Conduct Rule 3010 requires that NASD members "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]." The standard of "reasonableness" is determined based on the particular circumstances of each case.[59] The burden is on Enforcement to show that the respondent's conduct was not reasonable.[60]

It is undisputed that under Chase's procedures, Doherty was required to pre-approve KH's June 2001 investment of $650,000. In light of his earlier OTR testimony, the Panel did not credit Doherty's belated explanation for his signature on the Investment Manager Investment Pre-Approval Form at the Hearing. The Panel found that Doherty signed the form without gathering the necessary information to evaluate the transactions, and, in so doing, failed to exercise reasonable supervision over Respondent 1 in accordance with Chase's procedures. Similarly, the Panel found that Doherty signed off

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[57] CX-19, CX-22 at p. 64. During the Hearing, Doherty had a detailed recollection of his meeting with KH. He recalled speaking with KH about the transaction, and going over the differences between Class A and Class B shares. He also recalled discussing the transactions with Respondent 1, and recalled conducting an extensive review of the file, including the Asset Allocation Analysis, KH's Retirement Plan, and the Morningstar reports. (Tr. at p. 645-652) Again, the Panel credited Doherty's account during his OTR rather than his testimony at the Hearing.

[58] Tr. at p. 667-669.

[59] *See, e.g.*, Christopher Benz, 52 S.E.C. 1280 (1997).

[60] District Bus. Conduct Comm. v. Lobb, 2000 NASD Discip. LEXIS 11, at *16 (NAC Apr. 6, 2000) (citations omitted).

on the Blotters reflecting KH's June 2001 investments without first reviewing essential information regarding the transactions. The Panel found that Doherty also thereby failed to exercise reasonable supervision over Respondent 1.

Chase adopted written procedures that were designed to ensure compliance with applicable rules, including the NASD rules and pronouncements regarding sales of mutual funds. In order for the procedures to prevent violative conduct, they must be followed. Indeed, "it is a violation if the member and/or individual fails to enforce a supervisory system and/or written supervisory procedures. Either type of violation can occur in the absence of an underlying rule violation."[61] Even though the charges against Respondent 1 are dismissed, because the credible evidence establishes that Doherty failed to undertake the supervisory review required under Chase's procedures, the Hearing Panel found that he violated Rule 3010, as charged. By violating Rule 3010, he also violated Rule 2110.

C. Sanctions for Failure to Supervise (Doherty)

The NASD Sanction Guidelines ("Guidelines") for "Failure to Supervise" recommend a fine of $5,000 to $50,000, plus the amount of any financial gain. In addition, they recommend a suspension of the responsible individual in all supervisory capacities for up to 30 business days, and in egregious cases, a longer suspension of up to two years in any or all capacities, or a bar. Enforcement requested a six-month suspension and a $15,000 fine, but Enforcement's recommendation was premised on its

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[61] NASD Notice to Members 98-96, 1998 NASD LEXIS 121 at *5 (Dec. 1998). *See* NASD Notice to Members 96-32, 1996 LEXIS 51 at *4 (May 1996) (noting that a supervisory violation can occur without the occurrence of a separate underlying violation).

contention that Respondent 1's recommendations to KH were unsuitable, which the Panel has rejected.[62]

The "Failure to Supervise" Guidelines list specific considerations in setting sanctions for such violations, including the "[n]ature, extent, size, and character of the underlying misconduct," and the quality and degree of the supervisor's implementation of the firm's supervisory procedures.[63]

While the evidence did not establish any underlying misconduct, the Panel found that Doherty failed to implement the firm's supervisory procedures for pre-approval of certain investments and review of Blotters by ignoring significant, material omissions of information on required forms in this matter. The Panel also considered the following Principal Considerations generally applicable to sanctions.[64] First, Doherty did not accept responsibility or acknowledge that he had failed to supervise Respondent 1, even when confronted with forms that he signed that did not contain required information. Doherty instead took the position that the firm's procedures, indicating that a certain action "should" be taken, were optional. The Panel rejected this explanation, finding that it also evidenced Doherty's failure to take responsibility. The Panel also considered that Doherty did not offer a credible explanation for why his testimony at the Hearing was inconsistent with his OTR testimony.

Balancing the foregoing factors, and giving particular weight to the fact that there was no finding of liability for the underlying violation, the Hearing Panel determined that

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[62] Tr. at p. 733-734.

[63] Guidelines at p. 105 (2004 ed.).

[64] Id. at 8.

a suspension of 10 days in all supervisory capacities and a fine of $5,000 are appropriately remedial in this case.

IV. Conclusion

A preponderance of the evidence did not establish that Respondent 1 made unsuitable recommendations to a customer in violation of NASD Conduct Rules 2310 and 2110, and, accordingly, that charge is dismissed. However, Respondent Doherty failed to reasonably supervise Respondent 1's trading activities in violation of NASD Conduct Rules 3010 and 2110. He is suspended for 10 business days in all supervisory capacities and fined $5,000. In addition, he is ordered to pay costs in the amount of $5,440.20, which includes an administrative fee of $750 and transcript costs of $4,690.20.[65]

The foregoing sanctions shall become effective on a date set by the NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of the NASD, except that if this decision becomes NASD's final disciplinary action, Doherty's suspension shall begin at the opening of business on May 2, 2005 and end at the close of business on May 13, 2005.

HEARING PANEL

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By: Sara Nelson Bloom
Hearing Officer

[65] 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.

Copies to:

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