NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT Complainant, v. SCOTT EPSTEIN (CRD No. 4268699) Respondent.	Disciplinary Proceeding No. C9B040098 Hearing Officer – AWH **HEARING PANEL DECISION** October 31, 2005

Registered representative barred from associating with any member firm in any capacity for making unsuitable mutual fund switch recommendations to customers, in violation of NASD Conduct Rules 2110, 2310, and IM-2310-2; and, in connection with those transactions, making material misrepresentations and omissions of fact, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and NASD Conduct Rules 2110, 2120, and IM-2310-2. Respondent also assessed costs.

Appearances:

Michael J. Newman, Esq., Lynn M. Kaseta, Esq., and Gregory R. Firehock, Esq., For the Department of Enforcement

George L. Mahr, Esq., and Walter G. Luger, Esq., for Scott Epstein

DECISION

Introduction and Procedural History

I. Pre-Hearing Pleadings

On November 11, 2004, the Department of Enforcement ("Enforcement") issued a twenty-four-cause Complaint against Scott Epstein ("Epstein" or "Respondent"), alleging that he made unsuitable mutual fund switch recommendations, and, in connection therewith, material misrepresentations and omissions of fact, to twelve customers, in violation of NASD Conduct Rules and the Securities Exchange Act of

1934. On February 10, 2005, Epstein filed an Answer to the Complaint, denying the allegations and asserting the following three affirmative defenses: (1) that the Complaint was filed in order to interfere with an arbitration claim by Epstein against Merrill Lynch and certain individuals; (2) that the Complaint was filed to allow the attorney for the arbitration respondents to request a stay of those proceedings, and that unnamed "Senior Officials" have attempted to interfere with the arbitration proceeding; and (3) that the Complaint was filed in order to delay the arbitration proceedings until the Disciplinary Complaint in this proceeding has been concluded.

During a pre-hearing conference that was held by telephone on March 11, 2005, a hearing on the Complaint was scheduled for July 11 through 15, 2005, in Woodbridge, New Jersey. On April 27, 2005, Enforcement filed a motion to strike the affirmative defenses raised by Epstein in his Answer. That motion was unopposed, and, on May 17, 2005, the Hearing Officer granted the motion to strike the affirmative defenses, finding that they were not valid defenses to the causes in the Complaint.

On June 10, 2005, Respondent filed a 76-page Trial Brief and Statement of Facts, seeking to support an earlier pleading that requested (1) relief that had been denied by prior Orders, (2) permission to file an Amended Answer containing a counterclaim and additional affirmative defenses, (3) suppression of certain evidence, and (4) dismissal of the Complaint. By Order dated June 20, 2005, the Hearing Officer found that neither the Trial Brief nor the earlier pleading provided any rationale for granting the relief requested, and the Trial Brief concerned issues not germane to this proceeding. Specifically, the Order noted a previous Order that stated:

> "Respondent's complaints against high ranking Merrill Lynch representatives, which are the subject of a pending

> arbitration, may not be litigated in this disciplinary proceeding; nor will the purpose, adequacy, or techniques of NASD's investigation of the facts that led to this disciplinary matter be litigated during the hearing."

On June 20, 2005, the Department of Enforcement filed a Motion for a Preclusion Order, seeking to preclude Respondent from offering any testimony, except his own, or any documents into evidence, at the hearing or in connection with any pleadings that are filed, for failure to disclose a list of proposed witnesses and a list and copies of proposed exhibits, as required by the Pre-Hearing Order dated March 11, 2005. The Department of Enforcement asserted that it would be prejudiced by Respondent's failure to adhere to the deadlines in the Pre-Hearing Order. On July 1, 2005, Respondent filed what was styled as his "Second Amended and Supplemental Notice of Motion in Opposition to Department of Enforcement's Motion for a Preclusion Order," along with a 21-page Certification and Declaration of George L. Mahr, II, Esq., with four attached exhibits. In that submission, Respondent opposed Enforcement's Motion for Preclusion, and sought 17 separate Orders that essentially seek to vacate the prior Orders issued in this matter, grant the relief denied Respondent in those Orders, and "restrain" testimony of a senior investigator involved in the investigation that led to the institution of this proceeding.

On July 6, 2005, the Hearing Officer granted Enforcement's Motion to Preclude Evidence, noting that, notwithstanding the provisions of the Pre-Hearing Order, Respondent had not filed a list of witnesses that summarizes their expected testimony, nor had he filed and exchanged a list and copies of proposed exhibits. He had not filed, by the June 20, 2005, deadline, any objections or motions relating to the Department of Enforcement's proposed exhibits or witnesses; and he had not offered any reason why he had not complied with the deadlines contained in the Pre-Hearing Order that was issued

four months before the date of the scheduled hearing. The Order also referred to the limited nature of the Complaint, and stated that "Respondent cannot be allowed, in this proceeding, extensions of time to investigate or litigate matters that are the subject of a pending arbitration, delve into the nature of NASD's investigation of this case, or concern individuals who are not shown to have personal knowledge of facts relevant to the issues in this proceeding." Upon a finding that the Respondent's failure to disclose witnesses, along with the nature of their expected testimony, or exhibits that are proposed to be offered into evidence was both unjustified and not harmless, the Order precluded Respondent from offering any testimony, except his own, or any exhibits into evidence at the hearing or in connection with any pleadings that are filed. Finally, Respondent's 17 requests for Orders were found to be dilatory and repetitive, and that Respondent failed to show good cause for granting any of them.

II. The Hearing and Respondent's Default

A hearing on the twenty-four causes in the Complaint against Respondent was held on July 11 and 12, 2005, in Woodbridge, New Jersey, before an Extended Hearing Panel composed of the Hearing Officer and two former members of the District 10 Committee. Although Mr. Mahr and Mr. Luger appeared on behalf of Respondent on the first day of the hearing, Respondent did not attend that session. However, Respondent's parents attended that day's session. Immediately prior to the adjournment of that session, counsel for Enforcement stated that he expected to call Respondent as a witness at the hearing on the following day.

Respondent did not appear at the hearing on the second day, notwithstanding the oral notice given by counsel for Enforcement, as well as a written notice, issued by

Enforcement pursuant to NASD Conduct Rule 8210 after the close of the hearing on the first day, that he was required to appear and to give testimony on that second day of the hearing. Prior to the lunch break, counsel for Enforcement called Scott Epstein to testify. Mr. Mahr stated that Epstein was not at the hearing because he was "working." The proceeding was recessed for lunch, and when the proceeding resumed, counsel for Enforcement again called Scott Epstein to testify. Again, Mr. Mahr stated that Epstein was not present because he was working. Following a colloquy concerning disputed accounts regarding the service on the prior evening of the 8210 request for Epstein's testimony, Mr. Mahr gathered his belongings and, along with Epstein's parents, withdrew from the hearing room, abandoning any defense his client may have had to the allegations in the Complaint. Counsel for Enforcement then presented the direct examination of his expert witness, who was also examined by members of the Extended Hearing Panel, and a redirect examination of the NASD examiner who had previously testified. At the close of the hearing, counsel for Enforcement indicated his intention to file a motion for a default decision, based on Epstein's failure to appear and his counsel's abandonment of any defense. The Extended Hearing Panel then required that any post-hearing submission be filed on or before August 10, 2005.

On August 10, 2005, Enforcement filed its post-hearing submission and a Motion for Default and Adverse Inference Based Upon Respondent's Failure to Attend Hearing or Testify. Respondent did not file a post-hearing submission or a response to Enforcement's Motion for Default. Pursuant to Procedural Rule 9146(d), if a response to a motion is not filed, "the Party failing to respond shall be deemed to have waived any objection to the granting of the motion." Moreover, Rule 9269 permits the Hearing

Officer to issue a default decision against a Party who fails to appear at a hearing that the Party is required to attend by NASD Rules, and, where the Party is the Respondent, to deem the allegations against that Respondent admitted.

Because good cause has been shown for granting the Motion for Default, the Hearing Officer could grant it. However, under the particular circumstances of this case, where a sufficient record has been established after an oral hearing on the merits, the Hearing Officer will not issue a Default Decision against Respondent. Instead, the Extended Hearing Panel will issue its decision, basing that decision on the entire record.

Findings of Fact[1]

A. Respondent

After graduating from college, Scott M. Epstein began employment in the securities industry with Merrill Lynch on August 7, 2000. After passing the Series 7 Examination on October 13, 2000, he became a registered representative at the Hopewell, New Jersey, office of Merrill Lynch.[2] His assignment was to service pre-existing, generally low asset clients of the firm whose accounts were transferred to the Hopewell facility. Epstein was to respond to phone calls from those clients, make outgoing calls to them, and generally service their routine requests and investment needs.[3]

Epstein attested that he read, understood, and agreed to comply with the policies and procedures contained in Merrill Lynch's Compliance Outline Handbook for Private Client Financial Consultants.[4] That Handbook specifically requires registered representatives to discuss with clients interested in purchasing mutual funds:

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[1] References to Enforcement's Exhibits are designated as CX_, and the transcript of the hearing as Tr._.
[2] CX-1.
[3] CX-4 at 5, 7.
[4] CX-28.

- the advantages and disadvantages of the various available share classes, including front-end, back-end and level load shares,
- any restrictions on and/or cost associated with redemptions (e.g., CDSC [contingent deferred sales charges] charges, tender offer periods for floating-rate mutual funds),
- the existence and effect of any on-going distribution or maintenance fees,
- available discounts, including breakpoints, rights of accumulation, or letters of intent, and
- availability of no-cost or low cost shares, and
- where appropriate, various Merrill Lynch products through which mutual funds and unit trusts are available.[5]

The Handbook also states, "**You may not recommend a [mutual fund] switch unless it will result in a net investment advantage for the client,** considering all financial and other factors, including sales charges and tax consequences. The availability of a free or low-cost exchange with a fund/trust family and between different fund/trust groups must be considered and discussed." (emphasis in the original).[6]

Merrill Lynch's Mutual Fund Share Class Script was distributed to Epstein and other registered representatives for use in explaining to prospective investors important distinctions between mutual fund share classes. The Script stated, among other things, that Class C shares generally "make[s] most sense for: short-term investors; those investing smaller amounts [and] those who don't want a front-end load and understand the potential long-term effect of higher 12b-1 fees."[7]

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[5] CX-25 at 7.
[6] *Id*., at 8.
[7] Tr. 196-97; CX 30.

B. Epstein's Recommendations for the Twelve Customer Accounts

Merrill Lynch routinely recorded telephone conversations between customers and their registered representatives, including Epstein, at the Hopewell facility. At the hearing, transcripts of Epstein's telephone conversations with the twelve subject customers were introduced. In addition, the Extended Hearing Panel listened to the corresponding tape recordings of those conversations, and determined that the transcripts were consistent with the tapes, and that the tapes contained unedited conversation. The securities recommendations in those conversations were then analyzed by Enforcement's expert witness, Sidney Krasner, whose direct testimony was introduced in the form of a written report.[8] Mr. Krasner's findings were based upon his examination of documents contained in the NASD examination file, prospectuses for the relevant mutual funds, and the transcripts of conversations between Epstein and his customers. After supplemental direct oral testimony, Mr. Krasner was then questioned by the members of the Extended Hearing Panel. The tapes, transcripts, admitted exhibits, and testimony of Mr. Krasner all support the following findings:

<u>1. Customer TR</u>

On October 17, 2001, Epstein executed the following switch for the IRA of then 78-year-old customer TR:

> Sold $89,524 of Merrill Lynch High Income Bond Class B
> Bought $88,000 of Alliance US Government Bond Class B[9]

TR had owned the Merrill Lynch fund since 1993, long enough to avoid a contingent deferred sales charge ("CDSC") upon their sale. However, Epstein did not

[8] CX-2, CX-3.
[9] *Id.*, CX-5.

advise TR that his Class B shares automatically would have converted to Class D shares within less than two years, with a consequent decrease in operating expenses and an increase in his overall yield. Instead, the switch into the Alliance Class B shares subjected TR to a new CDSC holding period of four years, an increase in operating expenses, and an eight year waiting period for those shares to convert to Class A shares with lower operating expenses.[10]

Instead of recommending a switch to another family of funds, Epstein could have recommended that TR switch to the Merrill Lynch US Government Fund. Had he done so, TR would have had a cost free exchange, no new CDSC holding period, and conversion to shares with lower operating expenses in less than two years.

2. Customer DZB

On October 23, 2001, Epstein executed the following switch for the DZB Trust:

Sold $93,892 of Putnam NY Income Fund Class A
Bought $93,000 of Alliance Muni Income NY Portfolio Class C[11]

When Epstein called DZB, an unidentified man, later determined to be DZB's husband who was not the trustee for this account, answered the call. He claimed to be more knowledgeable about investing than DZB, and said that Epstein should speak to him. Epstein did not ask for the man's name or relationship to DZB. Epstein said that he would like to move the money in Putnam, "at not cost," to something that would provide "a better tax-free yield," a "full percentage point better."[12]

In fact, the performance of these two New York tax free funds, as measured by total return over a five year period, was almost identical. The total return for the Putnam

[10] *Id.*
[11] CX-2, CX-3, CX-6.
[12] CX-33.

Fund in 2000 was more than 200 basis points, or two percent, better than for the Alliance Fund. The Putnam Class A shares had an expense ratio of .82 percent, while the Alliance Class C shares had a higher expense ratio of 1.47 percent.[13]

Epstein failed to disclose the higher costs of the C shares or the fact that they required a one-year holding period. Moreover, Epstein failed to note that the sale of the Putnam shares would result in a large capital gain tax liability.

3. Customers FAO CD & EB

On October 30, 2001, Epstein executed the following switches for this joint customer account:

Sold $18,000 of Franklin Cust. Fund Class A
Sold $11,724 of Lord Abbett Bond Debenture Fund Class B
Bought $25,000 of Pimco Real Return Bond Fund Class C
Bought $5,000 of Merrill Lynch Core Bond Fund Class B[14]

Epstein had previously recommended the sale of some of the Franklin shares to buy Pimco shares. In recommending the switch on this date, Epstein did not disclose to the customers that the operating expense ratio of the Pimco Class C shares was almost double that of the Franklin Class A shares. The purchase of the Merrill Lynch Core Bond Fund was an addition to an existing position. Epstein erroneously informed the customers that the additional shares would have the same CDSC holding period that the pre-existing position had. The customers incurred a $275 CDSC charge on the sale of the Lord Abbett Class B shares, and a new CDSC holding period on the Pimco Class C shares. Moreover, had the customers retained the Lord Abbett shares, those shares would have converted eventually to Class A shares with lower operating expenses, while the Pimco C shares do not convert into other classes of shares. Epstein never offered the

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[13] CX-3.
[14] *Id.*, CX-7.

customers the option of free exchanges within either the Franklin or Lord Abbett fund families.

4. Customer GJ

On November 1, 2001, Epstein executed the following switch for the account of customer GJ:

Sold $20,750 of Merrill Lynch Balanced Capital Fund Class B
Bought $10,000 of Oppenheimer Quest Balanced Value Class B
Bought $10,000 of Pimco Renaissance Fund Class B[15]

Epstein received a call from GJ who wanted to withdraw $30,000 from her accounts. He recommended liquidating three positions to raise the cash. He then recommended reallocating money in the Merrill Lynch Balanced Capital Fund and another mutual fund into "maybe" a growth fund and a value fund to get the account a "little more balanced." Epstein never mentioned the name of the funds to which he was referring, and GJ did not appear to understand that he was seeking authority to effect trades. Her responses of "huh huh" and "mm-hmm" only indicated her reaction to the sale of investments to raise the cash she was requesting.[16]

GJ was not subject to a CDSC on the sale of the Merrill Lynch Balanced Capital Fund because she had owned it for approximately five and a half years. Those Class B shares would have converted to Class A shares, with about a one percent lower annual expense, in approximately two and a half years.[17] Epstein failed to discuss the fees and costs pertaining to the switch. He did not tell GJ that she would be subject to a new CDSC holding period and a longer period of increased operating expenses. He also failed to inform her that the Merrill Lynch and Oppenheimer funds were comparable

[15] CX-3.
[16] CX-35.
[17] CX-2, CX-50.

types of funds, and that the more cost effective switch would have been into another Merrill Lynch fund.[18]

5. Customer RR

On November 5, 2001, Epstein executed the following switches for the Trust account of RR and the IRA account of RR:

Sold $21,615 of Eaton Vance Virginia Muni. Fund Class B
Bought $21,000 of Alliance Muni. Inc. Fund Virginia Portfolio Class B
Bought $12,000 of Merrill Lynch Core Bond Fund Class B[19]

RR was a 75 year old widow at the time Epstein recommended that, in her trust account, she switch out of the Eaton Vance Virginia Municipal Bond Fund into a similar Alliance Fund that had a higher current yield. However, RR had purchased the Eaton Vance fund in September 1995 and was beyond the CDSC holding period. Her Class B shares would have converted to Class A shares in approximately two years, lowering the annual expenses from approximately 1.6 percent to .87 percent, and increasing her yield on the investment.[20] By switching into the Alliance fund, she was subject to a new six-year holding period with sales charges. Epstein never told her the name of the fund he was recommending, nor did he inform her of the new holding period. Moreover, he never discussed the fees and expenses of the two funds.

During the same conversation with RR, Epstein recommended that she liquidate money market funds in her IRA account to buy government bonds. She agreed. However, instead of buying bonds, which he had mentioned to her three times, Epstein bought Class B shares of Merrill Lynch Bond Fund Core Bonds. During the

[18] CX-2, CX-3, CX-8.
[19] CX-2, CX-3, CX-16B.
[20] CX-53 at 8.

investigation of this case, Epstein testified under oath that, during his phone conversation with RR, he explained Class B shares to her:

> I told her there was no charge up front and that there was a holding period on it. However, she mentioned in our conversation that she didn't really have a need for the money or was going to use it during that time period and we had decided that was the most appropriate share class for her.[21]

The recorded conversation with her, however, does not substantiate his testimony. He did not discuss with her the fees or expenses associated with this Fund, nor did he inform her of the CDSC holding period and related sales charges.[22]

6. Customer HM

On November 6, 2001, Epstein executed the following switch for the account of customer HM:

Sold $47,296 of Franklin Federal Tax Free Income Class A
Bought $47,000 of Nuveen Colorado Muni Bond Fund Class C

Epstein told HM that the switch would be at no cost to her. However, he failed to tell her that the Nuveen Fund expense ratio was more than double that of the Franklin Fund, and that the Nuveen Fund Class C shares would maintain the higher expense ratio for as long as she held them because they did not convert to Class A shares. He also failed to tell her that the total return for the previous three years for the Franklin Fund was 13.29 percent, compared to the Nuveen Fund's total return of 6.9 percent. He failed to discuss the option of switching into the comparable Franklin Colorado Tax Free Fund

[21] CX-4 at 15.
[22] CX-2, CX-3, CX-4.

which would have been a free exchange and avoided the Nuveen Class C one-year, one percent CDSC.[23]

7. Customers SA and MA

On November 9, 2001, Epstein called SA and executed the following switch for the account of SA and his wife, MA:

Sold $39,739 of Merrill Lynch Balanced Capital Fund Class D
Bought $38,000 of Oppenheimer Quest Balanced Value Class C

At the end of a conversation about the customers' expiring Municipal Investment Trusts, Epstein suggested that their Merrill Lynch Balanced Fund hadn't been performing "that well," and that they should consider reallocating into another balanced fund. Epstein never told SA, the 75-year-old husband, what the name of the other fund was, or that a shift into that Class C fund would result in an expense ratio of 2.06 percent, compared to his liquidated Class D shares that had an expense ration of only .84 percent. He also failed to tell the SA that the Class C shares were not convertible to shares with lower expenses.[24]

8. Customer KW

On January 8, 2002, Epstein executed the following switch for the account of customer KW:

Sold $21,843 of Alliance North American Gov't Income Trust Class A
Bought $21,000 of Merrill Lynch New Jersey Muni Bond Fund Class C

Epstein recommended this switch instead of cost-free switch to an Alliance New Jersey Municipal Fund, with no new CDSC holding period. While the Merrill Lynch Fund had annual expenses that were about one-half percent lower than the Alliance Fund,

[23] CX-2, CX-3, CX-9, CX-36.
[24] CX-2, CX-3, CX-10, CX-37.

the cost-free switch to the Alliance New Jersey Municipal Fund would have lowered the annual expenses by three-quarters of one percent and required no CDSC holding period.[25]

9. Customers WF and SF

On January 10, 2002, Epstein executed the following switch for the joint account of WF and SF:

Sold $44,863 of Alliance North American Gov't. Income Fund Class A
Bought $22,000 of Merrill Lynch Bond High Income Fund Class B
Bought $22,000 of Merrill Lynch Bond US Mortgage Fund Class B

Epstein told WF that the yield on the Alliance shares might be cut, and he recommended a switch to better quality bonds that have a higher yield. WF told him to "go ahead." Epstein never identified the bonds he was recommending, nor did he inform WF that, instead of bonds, he was going to buy two Merrill Lynch bond funds. Consequently, he did not discuss with WF any of the fees or expenses associated with the purchase of the Merrill Lynch Class B shares that had higher operating costs than the Alliance shares, in addition to a CDSC that the Alliance shares did not have. Although Epstein had recently recommended that customer TR purchase an Alliance government bond fund, he did not discuss the possibility of a cost free switch to another Class A Alliance fund with WF.[26]

10. Customer RG

On January 15, 2002, Epstein executed the following switches for the IRA account of RG:

Sold $43,336 of Merrill Lynch Balanced Capital Fund Class B
Bought $28,000 of Oppenheimer Quest Balanced Value Fund Class B
Bought $25,000 of Franklin US Gov't. Securities Fund Class B

[25] Tr. 120; CX-2, CX-14,
[26] CX-2, CX-3, CX-13, CX-41, CX-42.

RG had purchased the Merrill Lynch Fund on February 10, 1994, and, within three weeks of the switch transactions, his Class B shares would have converted to Class D shares, cutting the operating expenses from 1.61 percent to .84 percent. Instead, Epstein switched him to the Oppenheimer Fund that had comparable investment objectives, but an operating expense ratio of 2.06 percent. With some of the proceeds from the Merrill Lynch Fund, in addition to proceeds from another investment, Epstein switched RG to the Franklin Fund, although Epstein never told RG the name of that Fund or anything about its fees or expenses. The Franklin Fund had an operating expense ratio of 1.22 percent. Both the Oppenheimer and Franklin Funds had a new CDSC holding period. Epstein did not discuss the possibility of a cost-free exchange into another Merrill Lynch Fund.[27]

11. Customer DP

On February 11 and 12, 2002, Epstein executed the following switch in each of three custodial accounts DP had for her great-grandchildren:

Sold approximately $10,000 of Merrill Lynch Balanced Capital Fund Class B
Bought approximately $10,000 of Oppenheimer Quest Balanced Value Class B

Epstein told DP that the Oppenheimer Fund had a better performance record than the Merrill Lynch Fund that she had held in the three accounts since 1997. He told her that the switch would not cost anything. However, he did not tell her that the Merrill Lynch shares had almost run their CDSC holding period and would convert to Class D shares in three years. Those shares had a lower expense ratio than the Oppenheimer shares, and the expense ratio would decline even further once the shares converted to Class D. He did not inform her that the Oppenheimer shares would be subject to a new

[27] CX-2, CX-3, CX-15, CX-44.

six-year CDSC holding period, and he did not discuss with her the possibility of a cost-free exchange to another Merrill Lynch Fund.[28]

12. Customer VW

On February 25, 2002, Epstein executed the following switch for the account of VW:

Sold $27,168 of Merrill Lynch Balanced Capital Fund Class B
Bought $26,500 of Oppenheimer Quest Balanced Value Fund Class C

Epstein told VW that the switch would be at no cost to her. However, he did not tell her that the Oppenheimer Fund had an expense ratio of 2.06 percent compared to 1.61 percent for the Merrill Lynch Fund. Moreover, the Merrill Lynch shares had run the course of their CDSC holding period, and they would have converted to Class D shares in approximately two years, thereby lowering their expense ratio to almost half of what she was paying for the Class B shares. Finally, although he told her that she would have to hold the Class C shares for one year, he did not inform her that, if she liquidated the shares during that year, she would be subject to a one percent CDSC.[29]

Discussion and Conclusions

Unsuitable Switch Recommendations

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." Moreover, a representative must "make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status;

[28] CX-2, CX-3, CX-11, CX-38.
[29] CX-2, CX-3, CX-12, CX-39.

(3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such … registered representative in making recommendations to the customer."[30]

A broker's recommendations must be consistent with his customer's best interests.[31] A broker violates Conduct Rule 2310 if there is a showing that he lacked reasonable grounds for believing that his recommendation of a particular security was suitable for a customer or he failed to obtain information concerning the suitability of his recommendation before executing the transaction.[32]

In the case of mutual funds, NASD has directed its members to evaluate the net investment advantage of any recommended switch from one fund to another. Specifically, a broker recommending a switch should "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."[33] Moreover, brokers have been cautioned to take transaction fees into account in analyzing suitability: "Switching among certain fund types may be difficult to justify if the financial gain or investment objective to be achieved by the switch is undermined by the transaction fees associated with the

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[30] NASD Conduct Rule 2310(b). IM-2310-2(a)(2) cautions that the suitability rule is violated, even where the customer profits from a trade, if the sales efforts cannot "be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed…." A violation of Rule 2310 and IM-2310-2 constitutes a violation of Rule 2110 which requires observance of "high standards of commercial honor and just and equitable principles of trade." *See Jack H. Stein*, Exchange Act Release No. 47,335, 2003 SEC LEXIS 338 (Feb. 10, 2003).

[31] *Wendell D. Belden,* Exchange Act Release No. 47,859, 2003 SEC LEXIS 1154, at *11 (May 14, 2003).

[32] *See District Bus. Conduct Comm. v. Moore*, No. C01970001, 1999 NASD Discip. LEXIS 27, at *12-13 (N.A.C. Aug. 9, 1999) (finding respondent liable for failing to consider customers' overall financial situation, level of investment experience, sophistication, or financial needs).

[33] *Belden,* 2003 SEC LEXIS 1154, at *13.

switch."[34] In the end, a broker "should be able to demonstrate the rationale for recommending a particular fund to an investor . . . ."[35]

Here, the evidence demonstrates that the switches he recommended to the twelve customers were unsuitable for those customers. The only reason Epstein gave to his customers for recommending any switch was a conclusory statement that the recommended fund had a higher current yield than the fund the customer currently held. However, in suggesting that the customer's expected rate of return would increase by making the switch, he failed to take into consideration (1) the historical total return of each fund, (2) a comparison of their expense ratios, (3) the sales charge, if any, to be incurred where the CDSC holding period had not expired, (4) the application of a new CDSC holding period, (5) the eventual conversion of shares currently held to a class of shares with lower operating expenses, (6) the convertibility of shares in the new fund to classes with lower operating expenses, and (7) the opportunity to switch to other mutual funds within the same family of funds through a cost free exchange. He failed on occasion to identify the fund he was recommending; he spoke to a person who was not the account holder and was not authorized to place an order; and, in two cases, bought a bond fund after telling the customers that he would buy individual bonds.

The Extended Hearing Panel concludes that Epstein had no reasonable basis upon which to believe that any of the mutual fund switches were suitable for his twelve customers. Accordingly, by making those unsuitable recommendations, Epstein violated NASD Conduct Rules 2110, 2310, and IM-2310-2.

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[34] Notice to Members 95-80, 1995 NASD LEXIS 109, at *9.
[35] Notice to Members 94-16, 1994 NASD LEXIS 18, at *7.

Fraudulent Misrepresentations and Omissions

Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rule 2120 all "proscribe fraudulent conduct in connection with the purchase or sale of securities."[36] "Mutual fund switching violates the antifraud provisions of the federal securities laws when registered representatives, in order to increase their compensation, induce investors to incur the costs associated with redeeming shares of one mutual fund and purchasing another fund and the benefit to the customer does not justify those costs."[37]

To establish that Epstein violated the antifraud provisions of the federal securities laws and NASD rules as charged, Enforcement must prove by a preponderance of the evidence that he made misrepresentations or omissions of material facts, in connection with the purchase, sale, or offer of securities, and that he acted with scienter.[38] Recklessness suffices to show scienter.[39]

With respect to mutual funds, NASD has identified a number of "material facts" that a broker must disclose to the customer:

> To determine adequately whether a fact concerning a mutual fund investment would be material to an investor, the member must attempt to obtain information sufficient to

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[36] *Leslie E. Rosello*, Exchange Act Release No. 43,650, 2000 SEC LEXIS 2632, at **6-7 (Dec. 1, 2000).
[37] *Id.*
[38] *Dane S. Faber,* Exchange Act Release No. 49,216, 2004 SEC LEXIS 277, at **13-14 (Feb. 10, 2004). Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976).
[39] *See, e.g., Hollinger v. Titan Capital Corp*., 914 F.2d 1564, 1568-69 (9th Cir. 1990), *cert. denied,* 499 U.S. 976 (1991); *Kevin Eric Shaughnessy,* Exchange Act Rel. 40244, 1998 SEC Lexis 1507, *9 (July 22, 1998). Recklessness has been defined as highly unreasonable conduct involving not merely simple or excusable negligence but an extreme departure from the standards of ordinary care. *See Market Regulation Committee v. Jawitz,* No. CMS960238, 1999 NASD Discip. Lexis 24, at **19-20 (NAC July 9, 1999) (citing *Hollinger,* 914 F.2d at 1568-69 and cases there cited), *aff'd, Michael B. Jawitz,* Exchange Act Rel. 44357, 2001 SEC Lexis 1042 (May 29, 2001).

> evaluate the suitability of the proposed investment for that investor. Material facts may include, but are not limited to, the fund's investment objective; the fund's portfolio, historical income, or capital appreciation; the fund's expense ratio and sales charges; risks of investing in the fund relative to other investments; and the fund's hedging or risk amelioration strategies.[40]

Of particular importance to this case, NASD has clearly warned brokers to discuss the impact of all mutual fund fees and sales charges:

> To the extent there are sales charges associated with such a purchase or sale, such as contingent deferred sales charges on either the fund to be liquidated or the fund to be purchased, members should discuss with the customer the effect of those charges on the anticipated return on investment. Further, if a member recommends the purchase of a fund from a particular fund family based upon the ability to switch easily between funds in the family, the member should disclose all fees or charges that may be imposed.[41]

Specifically, because of the number of different share classes, "it is imperative that investors are told the differences among a front-end load, a spread load (deferred sales charge and 12b-1 fee), and a level load, and that they are instructed about why one type of fee may be higher or lower than another."[42] It is also important that a broker explain "how factors such as the amount invested, the rate of return, the amount of time the investor remains in the fund, and the fund's conversion features affect an investor's overall costs."[43]

Here, Epstein routinely misrepresented that the switches would be at no cost to the customer. To some customers, he misrepresented the current yields from the funds

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[40] Notice to Members 94-16, 1994 NASD LEXIS 18, at **2-2; *see* Notice to Members 95-80, 1995 NASD LEXIS 109, at *4.
[41] Notice to Members 94-16, 1994 NASD LEXIS 18, at *3; *Leslie E. Rosello,* 2000 SEC LEXIS 2632, at *8 (broker not absolved of responsibility to explain effect of fees even if customer understands that there are sales charges applicable to the switch).
[42] Notice to Members 95-80, 1995 NASD LEXIS 109, at *5.
[43] *Id.*, at **5-6.

they held and the funds he was recommending. Epstein routinely omitted to disclose to customers the following material facts: (1) investment objectives, (2) the fund's portfolio, (3) historical total return, (4) expense ratio, (5) sales charges, (6) risks of investing in the fund, and (7) the fund's hedging or risk amelioration strategies. Moreover, he failed to discuss the differences among various loads and the reasons for those differences; the impact of fund fees and sales charges on the anticipated return on investment; the extension of CDSC holding periods; or the automatic conversion of fund shares to classes with lower expense ratios. When he disclosed that a switch into Class C shares would involve a one-year holding period, he failed to disclose that those shares were usually not convertible to classes with lower operating expenses, even after the one-year holding period. Finally, he failed on a number of occasions to disclose the name of the fund shares he was planning to buy; on two occasions, failed to disclose to customers the type of security he planned to buy for them; and failed to note the tax consequences of the recommended switches to others.

There is also no question that Epstein acted with scienter. A preponderance of the evidence at the hearing demonstrates that he was aware of, or should have been aware of, the material information he failed to disclose to customers, as well as his duty to disclose that information to those customers. First, he was a college graduate who received and read various scripts and compliance documents from his firm that clearly prohibited misrepresentations and unsuitable recommendations, and unambiguously set forth disclosure and suitability duties and responsibilities. Second, as a General Securities Representative, he is charged with the knowledge of the securities laws and NASD

Rules.[44] Third, he had ready access to detailed information regarding the funds he recommended. Last, the recorded conversations demonstrate that he knew he was dealing with unsophisticated, vulnerable, often elderly customers who were relying on his recommendations, believing that they were made solely in their best interests. Epstein's omissions of the material facts noted above, and misrepresentations of the benefits the customers were purportedly to receive from the mutual fund switches he recommended, involved numerous customers over a period of several months. Clearly, those omissions and misrepresentations were an extreme departure from the standards of ordinary care, and therefore were reckless. By that conduct, he violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and NASD Conduct Rules 2110, 2120, and IM-2310-2.

Sanctions

For unsuitable recommendations, the NASD Sanction Guidelines recommend a fine of $2,500 to $75,000, and a suspension for a period of 10 business days to one year.[45] In egregious cases, the Guidelines recommend consideration of a longer suspension or a bar.[46] For intentional or reckless misrepresentations or material omissions of fact, the Guidelines recommend a fine of $10,000 to $100,000 and a suspension for a period of 10 business days to two years.[47] In egregious cases, the Guidelines recommend a bar.[48]

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[44] *Dep't of Market Regulation v. Ko Securities, Inc.*, No. CMS000142, 2004 NASD Discip. LEXIS 21, at **9-10 and n.7 (NAC Dec. 20, 2004) (citing cases).
[45] NASD SANCTION GUIDELINES, at 99 (2005).
[46] *Id.*
[47] *Id.,* at 93
[48] *Id.*

The violations all arise out of a common underlying cause − a pattern of making similar material misstatements and omissions to induce unsuitable mutual fund switching in the accounts of 12 customers over a period of several months. Accordingly, the Extended Hearing Panel aggregates the misconduct for purposes of imposing severe sanctions.[49]

For a number of reasons, the Extended Hearing Panel finds this to be an egregious case warranting the sanction of a bar.[50] In addition to engaging in a pattern of conduct over an extended period of time, Epstein recklessly engaged in that conduct without consideration of the customers' best interests. He received a "production credit" for each mutual fund transaction he effected, as long as the transaction was not a cost free exchange within a fund family. The evidence demonstrates that he always recommended that the customers in this case switch into a different fund family; he never recommended that those customer remain in the same fund family, even where the fund family was owned by his own employing firm.[51] Clearly, his misconduct resulted in the potential for monetary or other gain.[52] The customers were primarily elderly, unsophisticated, and vulnerable investors who unnecessarily incurred contingent deferred sales charges, extended holding periods, higher expenses, and lower yields as a direct consequence of Epstein's recommendations.[53]

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[49] *See Dep't of Enforcement v. J. Alexander Securities, Inc., et al.,* No. CAF010021, 2004 NASD Discip. LEXIS 16, at *69 (NAC Aug. 16, 2004).
[50] The Extended Hearing Panel has considered the entire list of Principal Consideration in Determining Sanctions listed in the Sanction Guidelines. GUIDELINES, at 6-7.
[51] Although he received production credits, there is no evidence of the amount of actual compensation he received as a result of the transactions at issue.
[52] GUIDELINES, Principal Consideration No. 17.
[53] However, there is no evidence of quantifiable customer loss. Accordingly, Enforcement seeks no order of restitution, nor would one be appropriate in the absence of such evidence.

Finally, Epstein has not challenged Enforcement's proof at the hearing, nor has he accepted responsibility for his misconduct. By his failure to testify at the hearing after having been given due notice, he has demonstrated not only an admission of egregious conduct, but also an unwillingness to conform his conduct to the high standards of commercial honor and just and equitable principals of trade mandated by NASD Rules. That unwillingness was also demonstrated by his effort to conceal his misconduct by giving false sworn investigative testimony about his discussions with customer RR.

Accordingly, for egregious violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and NASD Conduct Rules 2110, 2120, 2310, and IM-2310-2, Epstein will be barred from associating with any member firm in any capacity. He will also be assessed costs.

Conclusion

Scott M. Epstein is barred from associating with any member firm in any capacity for making unsuitable mutual fund switch recommendations to customers, in violation of NASD Conduct Rules 2110, 2310, and IM-2310-2; and, in connection with those transactions, making material misrepresentations and omissions of fact, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and NASD Conduct Rules 2110, 2120, and IM-2310-2. He is also assessed costs in the total amount of $4,398.20, consisting of a $750 administrative fee and a $3,648.20 transcript fee.

The bar shall become effective immediately if this Decision becomes the final disciplinary action of NASD.

SO ORDERED.

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Alan W. Heifetz
Hearing Officer
For the Extended Hearing Panel

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