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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. E9B2002055601 Hearing Officer – DMF **HEARING PANEL DECISION (Corrected)**[1] October 20, 2006

Summary

Complainant failed to prove by a preponderance of the evidence that Respondent recommended purchases of Class B mutual fund shares without having a reasonable basis for believing that they were suitable for the customers involved, in violation of Rules 2310 and 2110. Complainant did prove that Respondent failed to update his Form U-4, in violation of Rule 2110. For this violation he is fined $5,000.

Appearances

David F. Newman, Esq., (Rory C. Flynn, Esq., and Mark P. Dauer, Esq., Of Counsel) for Complainant.

Edwin Zipf, Esq., for Respondent.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on November 28, 2005, charging that Respondent violated Rules 2310 and 2110, and IM-2310-2, by recommending that certain customers purchase Class B mutual fund shares, without having a reasonable basis for believing that Class B shares—as opposed to Class A

[1] Typographical errors in references to the initials of one customer and to the numbers of the causes of the Complaint in the Conclusion have been corrected. Because of the non-substantive nature of the corrections, this Corrected Decision is issued nunc pro tunc.

shares—were suitable for the customers. The Complaint also charged that Respondent violated Rule 2110 and IM-1000-1 by failing to amend his Uniform Application for Securities Industry Registration (Form U-4) to disclose certain material information. Respondent filed an Answer contesting the charges and requested a hearing, which was held in Woodbridge, NJ, on July 11 and 12, 2006, before an NASD Hearing Panel.

II. Facts

A. Respondent

Respondent first became registered with NASD as an Investment Company and Variable Contracts Products Representative in 1990. In 2000, with a partner, ["Partner"], he opened NASD member firm [the "Firm"]. He is currently the sole owner of the firm, through which he is registered in a variety of capacities, including as a General Securities Representative and Principal. He has no prior disciplinary record and, apart from one customer in this case, has had no customer complaints during his career. (CX 1; Stip. 2-3; Tr. 93, 212-13.)[2]

B. The Fidelity Funds

The Complaint arises out of Respondent's sale of Class B shares of certain Fidelity Advisor mutual funds to four customers, including three married couples, each couple being counted as a single customer for purposes of this decision: KK, H&AR, J&MT and P&JO. As with other mutual funds sold through independent broker-dealers, at the relevant time Fidelity Advisor mutual funds were available to investors in several different classes, including Class A shares and Class B shares, with identical investment

[2] In this decision, "CX" refers to Complainant's exhibits; "RX" to Respondent's exhibits; "Tr." to the transcript of the hearing; and "Stip." to the Joint Stipulations filed by the parties.

objectives and portfolio holdings, but different cost structures. (CX 36-37, 47; Tr. 29-30.)

For Class A shares, an investor paid a front-end sales load, which reduced the net investment amount. The amount of the front-end sales load depended upon the amount invested: 5.75% for purchases under $50,000; 4.5% for $50,000 to $99,000; 3.5% for $100,000 to $249,999; 2.5% for $250,000 to $499,999; 2% for $500,000 to $999,999; 1% for $1 million to $24,999,999; and nothing for investments of $25 million or more. The amounts at which sales loads are reduced are referred to in the mutual fund industry as breakpoints. (CX 36-37, 47; Tr. 30-33, 97-99.)

If an investor's initial purchase of Class A shares was insufficient to reach a particular breakpoint, the investor could still obtain a lower sales load by making a written commitment to Fidelity to invest additional funds within a 13-month period (a letter of intent). So, for example, an investor who initially invested $200,000, but provided a letter of intent to invest an additional $200,000 within 13 months, would pay a sales load of 2.5%, rather than 3.5%, on both the initial investment and the subsequent investment. Alternatively, even if the investor did not give Fidelity a letter of intent at the time of the initial investment, the investor was entitled to a lower sales load on subsequent investments if, in the aggregate, they exceeded a breakpoint. For example, if the investor had paid a 3.5% sales load on the initial purchase of $200,000, he or she would pay only 2.5% on a subsequent $200,000 purchase. This is referred to as a right of accumulation. In addition to the front-end load, Fidelity Class A investors were assessed operating expenses, but they paid no sales charge when they sold their Class A shares. (Id.)

In contrast to Class A shares, investors who purchased Fidelity Advisor Class B shares paid no front-end sales load. Because of this, the net investment amount was higher with Class B shares than with Class A shares. But Fidelity charged Class B share investors operating expenses that were approximately 0.74% per year higher than the expenses that Class A share investors paid. In addition, Fidelity charged a contingent deferred sales charge (CDSC) on the sale of Class B shares. The CDSC decreased each year, beginning at 5% during the first year and eventually reaching 0% after six years. Seven years after purchase, Class B shares converted to Class A shares, with the corresponding lower Class A share annual fees and no CDSC. From the outset, however, a Class B share investor could withdraw up to 10% of the investment principal each year, as well as any accrued market gains or dividends, without incurring a CDSC. And investors could exchange their Class B shares in one fund for Class B shares in other Fidelity Advisor funds without incurring a CDSC. (Id.)

Therefore, determining whether an investor who wished to purchase Fidelity Advisor funds would be better off purchasing Class A or Class B shares required consideration of, among other things: (1) the amount of shares the customer expected to purchase, initially and in the future; (2) the length of time the investor expected to hold the shares; (3) the investor's anticipated need to draw money from the mutual funds in amounts that would, or would not, incur CDSC charges; and (4) the investor's own investing preferences.

C. Suitability

1. Customer KK

The hearing focused principally on KK, the only one of the four customers who raised any complaint against Respondent. As of the Fall of 2001, Respondent and his wife had been acquainted with KK and her husband WK for some time. In late October 2001, KK filed a divorce complaint and began spending a good deal of time with the [Respondent and his wife] at their home. Although KK's husband was wealthy, KK had little financial acumen or investing experience. She did, however, have an account at another NASD member firm in her own name, which her husband had opened on her behalf and in which he had deposited $1 million in common stock. By the time she filed for divorce, however, the value of that account had diminished to approximately $660,000. (Tr. 99-100, 225.)

KK told Respondent that she did not trust her husband or the firm at which he had established the account, and asked him to open an account for her at the Firm and transfer the stock holdings from the other account.[3] KK's Firm account was opened on November 6, 2001. (Tr. 100-01, 225; Stip. ¶ 4.)

KK also told Respondent that, in light of the losses she had incurred, she wanted to sell all the stocks in the account. He recommended that she sell only the stocks in which she had gains before the end of 2001, on the theory that she would benefit because she and her husband would be filing a joint tax return, and that she not sell her losing positions until 2002, when, presumably, she would be filing a tax return on her own.

[3] This is confirmed by the "Request to Switch Investment" section of the new account form that Respondent completed and KK signed when she opened her Firm account: "I lost $340,000 and do not want to be involved with them or any other investments they have made." (CX 4 at 5.)

Respondent also recommended that KK use the funds from the 2001 sales to purchase Fidelity Advisor mutual funds.[4] (Tr. 101-02, 226, 230-34, 244.)

Respondent and KK discussed the various classes of shares that were available, including Class A and Class B shares, and Respondent prepared a hand-written, detailed comparison of the costs and benefits of the various classes for KK during the discussion. In his comparison, Respondent disclosed the higher up-front costs of Class A shares—he assumed a 2.5% sales load based upon an investment of $460,000, the amount KK expected to derive from the 2001 sales of her profitable stocks—compared to no front-end sales load for Class B shares. He also disclosed that Class B shares had a CDSC, and the diminishing amount of CDSC that would apply each year, and that Class B shares had higher annual expenses than Class A shares. (CX 5; Tr. 236-38.)

Respondent's comparison also showed the potential value of Class A and Class B shares after five years, so KK could "visually see the differences between an A and a B fund." Applying fairly conservative assumptions, Respondent calculated that a $460,000 investment in Class A shares would be worth approximately $658,000 at the end of five years, compared to approximately $645,000 for Class B shares using the same assumptions, a $13,000 advantage for Class A shares. Respondent also explained to KK that she could withdraw up to 10% per year from Class B shares, plus any gains she had realized, without incurring any CDSC, and that taking such withdrawals could reduce or

[4] Consistent with his testimony, at the time KK opened her account, Respondent prepared, and KK signed, two Firm "Request to Switch Investments" forms. One form stated: "I want all investments [the other firm] moved and sold. I do not trust them—I have lost $340,000." This form was marked "unsolicited," and, in fact, Respondent charged no commissions on the sales of those securities. The other form indicated that KK would be purchasing "Fidelity Advisor 'B' shares," and stated that "Client wants to force spouse to pay [capital] gains tax before their divorce." This form was marked "solicited." Respondent testified that he used two different forms in order to reflect that he had not solicited KK's decision to move the account to the Firm and sell the securities in the account, but had solicited her decision to sell only the securities in which she had gains in 2001 and to purchase Fidelity Advisor shares with the proceeds of those sales. (CX 14 at 2, 3; Tr. 232-34.)

eliminate the apparent advantage for Class A shares over the five year period. At KK's request, Respondent also prepared a comparison of the value of Class A and Class B shares if sold after two years, using the same assumptions, which showed essentially no difference in value between Class A and Class B shares. Enforcement did not challenge the assumptions used by Respondent, the accuracy of his calculations, or his contention that taking withdrawals that did not incur CDSC charges could reduce or eliminate any financial disadvantage to KK from the purchase of Class B shares. (CX 5; Tr. 238-40.)

Neither the five year nor the two year comparison that Respondent prepared considered the breakpoint that KK could attain if she gave Fidelity a letter of intent to invest the additional funds she would receive when she sold the balance of her stock in 2002. If KK had given Fidelity such a letter of intent, her front-end load for Class A shares would have been reduced to 2%, rather than the 2.5% Respondent used in his calculations. If Respondent had prepared his comparisons using the 2% load, they would have shown a somewhat greater advantage for Class A shares, compared to Class B shares, over both five years and two years. Respondent testified, however, that in December 2001, KK indicated that she intended to keep the 2002 sales proceeds in cash, rather than invest that money in Fidelity Advisor funds. This expectation was based at least in part on the fact that her husband, WK, had stopped her allowance and cancelled her credit cards when she filed for divorce. (Tr. 108, 235.)

KK sold a portion of her stock and invested $450,000 in Class B shares of several Fidelity funds in December 2001. Respondent testified that, even though his calculations showed a somewhat greater value for Class A shares if held for five years, and KK expected to hold the funds for "five plus, six plus, ten years," KK was "stuck on buying B

shares and didn't want to pay anything up front." Moreover, because of her pending divorce, she expected to withdraw money from the funds to live on, and thought that the fact that she could draw only 10% of her principal from Class B shares without incurring any CDSC expense would help her control her spending. (Tr. 239-41, 257, 328-29; CX 8.)

In January 2002, Respondent sold the balance of KK's securities, as planned. Respondent testified that by that time KK's attorney had worked out support arrangements from her husband, so she decided to use the sales proceeds to purchase additional Fidelity Advisor fund shares, instead of keeping the money in cash. Even though she had not given Fidelity a letter of intent when she made her initial purchase in December, she could have used a right of accumulation to reduce the front-end load to 2% if she purchased Class A shares. In addition, it is possible that, at Fidelity's discretion, KK might have been able retroactively to convert her original Class B share purchase in December 2001 into Class A shares, in order to obtain a 2% front-end load on that purchase as well. Respondent testified that he again discussed the purchase of Class A shares with KK, but she was still opposed to paying any front-end load, and therefore elected to purchase additional Class B shares totaling $180,000. (Tr. 111-14, 241-42, 293, 330; CX 47; Stip. ¶ 5.)

In February 2002, KK invested an additional $38,000 in Fidelity Advisor Class B shares. Once again, if she had bought Class A shares, she would have been entitled to a 2% front-end load, using a right of accumulation based upon her prior purchases. Respondent testified, however, that she remained "adamant about not wanting to pay the load." (Tr. 115-16; CX 47; Stip. ¶ 5.)

In approximately May 2002, KK reconciled with her husband, WK, apparently against the advice of the [Respondent and his wife]. WK strongly objected to Respondent's sale of the securities from the account KK transferred to the Firm, complaining, in particular, that Respondent's recommendation that she sell the securities in which she had gains in 2001 and the ones in which she had losses in 2002, was against her tax-planning interests. KK told Respondent that her husband insisted that she transfer her account away from the Firm. Respondent suggested that she ask Fidelity to "un-network" her funds, so they could be held directly with Fidelity, and he prepared documents to attempt to accomplish that, which KK signed. It is not clear whether "un-networking" the funds would have been possible, but in any event, KK contacted the Firm's clearing firm and indicated that she wanted to liquidate her Fidelity Advisor funds. Respondent then sent KK a letter warning her that liquidating her Fidelity Class B shares was "not prudent" and that she would "incur a substantial contingent deferred sales charge upon liquidation of your account. Therefore, I am recommending that you consider assigning your account to another Registered Financial Advisor and Broker-Dealer." KK did subsequently transfer her account to another firm, but after transferring the account, she sold all her Class B shares in an unsolicited transaction, incurring a large CDSC, just as Respondent had warned. (Tr. 145, 150-51, 200-02, 242-43; CX 18, 24; RX 10.)

KK testified at the hearing and disputed Respondent's testimony in certain material respects, but she was not a credible witness. Respondent's story has been consistent since NASD staff first asked him to explain KK's purchases of Class B shares, and it comports with the documentary evidence, including the account opening

documents signed by KK. In contrast, KK's story has been inconsistent and at odds with the documents. Most significantly, prior to the hearing, KK repeatedly claimed that Respondent never explained to her the differences between Class A and Class B shares, or gave her the option of purchasing Class A shares. At the hearing, however, confronted with the written record of Respondent's presentation, she was forced to concede that, in truth, he gave her a detailed comparison of both share classes. She claimed, however, that he "was writing very fast and he talked fast" when he presented the information, so she did not understand it. But as Respondent pointed out, in order to create a detailed handwritten comparison for her during their discussions, he had to make mathematical computations comparing the costs and benefits of Class A and Class B shares, and therefore could not have rushed through his presentation as KK claimed. (Tr. 140-42, 206-07.)

More generally, it was clear from KK's demeanor, as well as the substance of her testimony, that her recollection of the relevant events, and her resulting anger towards Respondent, has been significantly colored by her husband's and others' criticism of her purchase of Class B shares, and by her own very limited investment knowledge; that is, she appeared to be recalling events as she wished they had occurred, rather than as they actually happened. As a result, the Panel found KK's testimony less reliable than Respondent's.

2. Customers H&AR, J&MT and P&JO

Customers H&AR, J&MT and P&JO also purchased Class B Fidelity shares through Respondent. None of these customers has ever registered a complaint about their purchases of Class B shares. They remain customers of Respondent, and none was

willing to cooperate with Enforcement's investigation of Respondent or to testify for Enforcement at the hearing. Indeed, Respondent listed all of these customers as witnesses willing to testify on his behalf, and customer AR testified for him at the hearing, by telephone.

H&AR opened a joint account with Respondent at the Firm in March 2001, and in October 2001 each opened an IRA account with him. From October 2001 through February 2002, H&AR purchased Fidelity Advisor Class B shares in their joint account and their IRAs totaling more than $900,000. As husband and wife, if they had purchased Class A shares H&AR could have combined their purchases in all three accounts to attain reduced-load breakpoints through a letter of intent or rights of accumulation. H&AR have paid higher annual fees for their Class B shares than they would have paid for Class A shares, but they have not made any sales that triggered a CDSC charge. (Stip. ¶¶ 8-9; Tr. 32, 336; CX 25-28.)

J&MT had accounts with Respondent at his prior employer. After he founded the firm, they opened a joint account and IRAs there in August 2000, and transferred their holdings from the prior firm to their Firm accounts. Between February 2000 and August 2002, J&MT purchased more than $965,000 in Fidelity Class B shares in their joint account and their IRAs. Once again, if they had purchased Class A shares, they could have combined their purchases to achieve breakpoints. They have paid higher annual fees for their Class B shares than they would have paid for Class A shares, but have not made any sales that incurred CDSC charges. (Stip. ¶¶ 10-11; CX 29-32; Tr. 263-66, 336.)

P&JO opened IRA accounts with Respondent at the Firm in August 2000. In September 2000 and March 2002, P&JO purchased a total of $542,500 in Fidelity Advisor Class B shares in their IRAs. They could have combined their purchases to achieve breakpoints if they had purchased Class A shares. They have paid higher annual fees for the Class B shares, but have not incurred any CDSC charges. (Stip. ¶¶ 12-13; CX 33-35; Tr. 336.)

Respondent testified that his practice with all his customers, as with KK, was to explain the various available mutual fund share classes, including the differences in up-front loads, yearly costs and CDSC, before they invested. "The first step of the presentation always was to discuss what in general a mutual fund[] is all about. … Once we decide[d] that funds [were] the solution, … this is where I would describe to them what the classes were that were available …. That's a decision that I did not like to take on myself. I like to explain to them the difference …." Respondent stated: "I always either verbally or graphically try to give [the customers] a layman['s] presentation of the differences between A and B shares …, so that they have a layman's … way of understanding what they are going to be committing to …." AR confirmed that Respondent did not urge the purchase of Class B shares—"he just explained both the options that we had and we made the decision to go into B." (Tr. 133, 217-18, 414.)

With respect to H&AR, Respondent testified that he "recommended Fidelity funds to [them] but had a very lengthy disclosure with them about what the costs would be A versus B shares." But HR, in particular, "was adamantly against buying A Shares," and H&AR planned to retire and take systematic withdrawals from their funds, in amounts that would not trigger CDSC charges. So "after a very lengthy time with them;

and, again, their unwillingness to pay a load, I would say there was a recommendation made that B shares would be the better alternative … over the long [haul]." Respondent testified that he "would have preferred, perhaps, that [H&AR] purchased A; but, you know, working with so many people in so many circumstances and so many different situations, I'm not in control of them …." AR confirmed that Respondent explained the differences between Class A and Class B shares and did not urge the purchase of Class B shares, but stated that she and her husband decided to purchase Class B shares because "we didn't want a front load," even though she recognized that "[s]ome way you have to pay somewhere." (Tr. 118, 330-32, 416, 420.)

J&MT are long-time customers of Respondent and over the years they have purchased both Class A and Class B mutual fund shares through Respondent, as well as Class C shares, and Respondent discussed the characteristics of the various share classes with them. Respondent testified that "[JT], more or less, kind of dictates to me, you know, this is what I want … he's a strong character …. For some reason, people have a hard time with 15, $18,000 loads up front starting their balances off, even though … I try to emphasize to them that over time, they will recoup that …." JT did not want to pay the front-end load for Class A shares; "he, more or less, just said, this is the way he wanted it and, at some point, I agreed with him." (Tr. 264-66, 333-34.)

P&JO already owned Class B mutual fund shares in their IRA when they moved those accounts to the Firm, but were dissatisfied with the performance of their investments. They sold some of their Class B shares and purchased Fidelity Advisor Class B shares. Respondent testified that when he and the customers discussed selling the Class B shares, he "gave them a quick verbal, ['']look, you recognize you have shares

in there that have a CDSC charge and there's a potential that if you go into new shares that you are going to have a new front load or have the same condition with B shares and I just want to give you an understanding of that, give you a heads up on that[']…." But "[BO] was going to be paying a CDSC charge for some of the shares he was very, very dissatisfied with and then he didn't want to turn around and have a lower amount of money going in [the new investments]. Again, the condition here is … the fact that the front load is a deterrent …." Therefore, they decided to purchase additional Class B shares. P&JO also planned to take regular withdrawals from their funds. (Tr. 119, 258-63, 316, 334-35; CX 34-35.)

D. Failure to Amend Form U-4

1. Website Complaint

In June 2002, Respondent's partner, who was the firm's compliance officer, received through the mail an unsigned letter asserting, among other things, that Respondent "irresponsibly and erroneously advised" KK in various respects. The Partner wrote a memo to the firm's compliance file indicating that the letter "appears to be from [WK]," and that, after speaking to Respondent and "review[ing] the client file and all documents," he had come "to the conclusion that this letter did not meet the criteria of a formal complaint as it was not dated, signed and did not appear to be from the client. … For these reasons I do not feel a reporting on form U-4 or U-5 are in order." (CX 16.) Enforcement does not charge Respondent with any violation based on this letter.

On December 4, 2002, however, NASD staff sent a letter to the Partner, on behalf of the firm, enclosing a customer complaint that had been filed on NASD's website on November 26, 2002. The complaint was in the name of KK, and asserted:

> [Respondent] purchased $600,000.00 plus in Fidelity Mutual Funds 'B Shares'. He knew that I had concerns regarding liquidity. He never explained the difference in fees and charges between the Class B Shares that I bought and other Classes that were available. He never used the word 'BREAKPOINT' with me and I purchased these shares based on his recommendations to me. He also misled me about my portfolio.

(CX 2.)[5]

Respondent did not file an amendment to his Form U-4 disclosing the website complaint. He testified that he did not believe he was required to disclose it because he thought it had actually been filed by WK, rather than KK. KK, however, testified that after her attorney suggested that she contact NASD and gave her NASD's website address, she went on the website and wrote the complaint "[w]ith the help of my husband." (Tr. 154-55, 349-50.)

2. <u>Wells Letter</u>

In March 2004, NASD staff sent Respondent's counsel a "Wells" letter notifying him that the staff had made a preliminary determination to recommend that a disciplinary action be brought against Respondent, alleging that he had made unsuitable recommendations. The letter advised that it constituted "written notification that [Respondent] is the subject of an investigation for purposes of triggering an obligation on his part to update the Form U-4 …)." (CX 40; Tr. 316; Stip. ¶ 18.)

Respondent and his wife, who was associated with the Firm at the relevant time, testified that in June 2004 they attempted to file an amendment to Respondent's Form U-

[5] The staff requested a response to the complaint and various firm records. Because the Partner was undergoing medical treatment and unavailable, Respondent sent a prompt response to the staff on the firm's behalf addressing the staff's questions and providing the requested documents. In January 2003, NASD staff sent a second request for information, and the Partner responded with the requested information and documents. In June and July 2003, NASD staff sent additional requests for information to which Respondent responded with the requested information and documents. As noted above, his responses and the documents he and the firm provided were consistent with his testimony at the hearing. (CX 2-3, 6-7; 10-14.)

4 disclosing the Wells letter. Form U-4 amendments are filed electronically through Web CRD. Respondent's Partner, who had been the firm's compliance officer and was familiar with the process for amending U-4 Forms on Web CRD, was out of the office for health reasons, so Respondent and his wife obtained the required authorizations to submit amendments. They testified that they contacted NASD staff and followed the directions they were given in order to amend Respondent's Form U-4. This was the first time either of them had attempted to amend a Form U-4 on Web CRD. Notwithstanding their efforts, according to Web CRD records, Respondent's Form U-4 was not amended to disclose the investigation until June 29, 2005, after NASD staff notified Respondent that his Form U-4 had not been amended and that they intended to charge him with a violation. (Tr. 280-81, 436-37, 442, 445, 453-54; Stip. ¶¶ 19-21.)

Enforcement called a staff witness, Heather Eisenhour, to describe the manner in which Web CRD is used to amend a Form U-4, and the Web CRD records regarding amendments to Respondent's Form U-4. As she explained in detail, the process to file an amendment requires several steps, and if all steps are not completed properly, the amendment will not be accepted by Web CRD and reflected on the Form U-4. If a filing is begun, but all steps are not completed, it will be shown in the system as a pending filing, but if the filing is not properly completed and submitted within 60 days, it is purged by the system. According to the witness, Web CRD records show that a filing to amend Respondent's CRD was begun on June 14, 2004, by Respondent's wife, but not properly completed and submitted. It was purged from the system 60 days later. As Respondent knew, it was possible to confirm that the amendment had been properly submitted and accepted by returning to Web CRD and checking the Form U-4, which

should have reflected the amendment. In addition, a check of the Web CRD pending filings section would have shown any filing begun, but not properly completed and submitted, for 60 days, until it was purged. (Tr. 317, 364-400; CX 45.)

III. Discussion

A. Suitability

The Complaint charges that Respondent violated Rule 2310 by recommending that the customers purchase Fidelity Advisor Class B shares, rather than Class A shares, without having a reasonable basis for believing that Class B shares were suitable. Enforcement does not contend that the funds selected or the amounts the customers invested in those funds were unsuitable; rather, Enforcement asserts that Class B shares were unsuitable for the customers only because they were more costly than Class A shares. Enforcement argues that the higher annual fees Fidelity charged for the Class B shares, together with the CDSC charges the customers could incur if they sold their shares, more than offset the front-end loads for Class A shares, particularly since the customers would have been eligible for breakpoints through the use of letters of intent or rights of accumulation.

Rule 2310 requires that registered representatives such as Respondent have "reasonable grounds for believing" that their recommendations are suitable for their customers in light of "the facts, if any, disclosed by such customer as to … his financial situation and needs."[6] As the Complainant, Enforcement had the burden of proving by a preponderance of the evidence, that Respondent violated this provision. Department of

[6] The rule itself refers only to members, but Rule 115 provides: "Persons associated with a member shall have the same duties and obligations as a member under these Rules."

Enforcement v. Respondent, No. C07010037, 2003 NASD Discip. LEXIS 16 (N.A.C. May 13, 2003).

Apart from KK, whose testimony was not credible, Enforcement's case rested on the calculations of its expert witness, Sidney D. Krasner, purporting to show the additional costs the customers incurred because they purchased Class B shares, rather than Class A shares. Krasner has been employed as a consultant and expert witness for many years; he has not worked in the securities industry since 1992. His expert opinion in this case was essentially limited to "strictly a numbers analysis," in which he applied the load, expense and CDSC schedules set forth in Fidelity Advisor prospectuses to the amounts of the customers' Class B share purchases. His understanding of the Fidelity Advisor funds was based upon reading the prospectuses and a few informal telephone conversations with Fidelity employees; Enforcement offered no testimony from Fidelity employees or others who might have had first-hand, expert knowledge of the various classes of Fidelity Advisor funds, or of industry standards and practices relating to investing in those share classes at the relevant time. (CX 47; Tr. 49, 58-59.)

Krasner calculated that it cost KK $16,573 more to own the Class B shares she purchased than it would have cost her to own Class A shares. In arriving at this figure, Krasner assumed a 2% sales load for KK's initial purchase of Class A shares in December 2001, rather than the 2.5% that she actually paid, on the theory that KK could have given Fidelity a letter of intent to invest the funds that would become available when she sold additional stock in 2002. However, Respondent testified credibly that at the time KK made the December 2001 purchase, she intended to hold the money she expected to receive in 2002 in cash, not invest it in additional Fidelity Advisor funds.

More significantly, Krasner's calculation included the $26,616 CDSC charge that KK incurred when she liquidated her entire investment in Fidelity Class B shares after she transferred her account to another firm. KK made that unsolicited sale notwithstanding Respondent's warning that she would incur a CDSC.[7] (CX 47.)

Krasner's calculations for customers H&AR, J&MT and P&JO also included CDSC charges, even though those customers have never incurred such charges. And his calculations for all the customers ignored any possible benefit they might have enjoyed as a result of having higher net investments in Class B shares than they would have had if they purchased Class A shares and paid front-end loads. Krasner did not challenge the accuracy of Respondent's calculations in the comparison he prepared for KK, or Respondent's contention that KK's plan to make withdrawals from her funds in amounts that would not trigger CDSC charges would reduce or eliminate the apparent advantage for Class A shares. Most significantly, in concluding that Class B shares were unsuitable for the customers, Krasner gave no weight to the customers' unwillingness to pay the front-end loads they would have incurred if they purchased Class A shares. (CX 47; Tr. 58-59.)

"[A] registered representative's suitability obligation encompasses the requirement to minimize the sales loads that a customer pays for mutual fund shares, when consistent with the customer's investment objectives." Department of Enforcement v. Belden, No. C05010012, 2002 NASD Discip. LEXIS 12 at *13 (Aug. 13, 2002), aff'd,

[7] There is no indication that KK was forced to make the sale to meet financial obligations. On the contrary, KK testified that after she sold the Fidelity Advisor Class B shares, she kept the proceeds in cash for a period of time before following a recommendation that she invest the funds in a limited partnership. (Tr. 209-10.) Krasner also assumed that KK paid a CDSC when she sold approximately $50,000 of her Class B shares in April 2002, but her account statement does not support that assumption, because it indicates she netted all but about $32 of the gross proceeds of the sale. (CX 8 at 22.)

Exchange Act Rel. No. 47859, 2003 SEC LEXIS 1154 (May 14, 2003). In Belden, the respondent testified "that he never purchased Class A shares and that it was his policy to place customers in Class B shares," because he "believed that he could not stay in business without getting the higher commission fees that Class B shares paid him." Id. at *8, 14.

In contrast, here the credible evidence is that Respondent gave the customers complete and accurate information regarding the differences between Class A and Class B shares, and did not urge them to select Class B shares. Indeed, the calculations he prepared for KK showed that, under the assumptions he used, Class A shares would be worth more than Class B shares after five years. It appears that the customers elected to purchase Class B shares not because Respondent urged them to do so, but because they were highly averse to paying front-end sales loads, and that Respondent "recommended" the Class B shares only in the sense that he advised the customers that, given their aversion to front-end loads, Class B shares best suited their objectives. [8]

Enforcement points out that Respondent received higher commissions for selling the Class B shares than he would have received if the customers had purchased Class A shares, implying that Respondent steered the customers to Class B shares to further his own financial interests. But Enforcement failed to offer credible evidence to support this contention. Indeed, Enforcement's own evidence included the comparison that Respondent gave KK, which tended to suggest she would be better off purchasing Class A shares. AR also testified that Respondent did not urge the purchase of Class B shares.

[8] By way of contrast, see IFG Network Securities, Inc., Exchange Act Rel. 54127, 2006 SEC LEXIS 1600, at *19 (July 11, 2006), where the SEC stated that the respondent claimed that, because many of his customers were averse to paying up-front loads, "'there was no need to keep beating [the customers] over the head' by telling them about the availability of breakpoint discounts and other elements of the expense structure of investments in Class A shares and about other distinctions between the two share classes."

The only evidence supporting Enforcement's contention is the testimony of KK, which, for reasons set forth above, was not credible.

Moreover, in purchasing Class B shares, the customers were in the mainstream of investors at the time. According to the two Fidelity fund prospectuses in evidence, the amounts invested in Class B shares of the funds far outstripped the amounts invested in Class A shares. For example, as of November 30, 2000, the last date covered by the prospectus for the Fidelity Advisor Large Cap Fund, more than $150 million was invested in Class B shares of that fund, compared to less than $38 million in Class A shares, while as of November 30, 2002, the last date covered by the prospectus for the Fidelity Advisor Dividend Growth Fund, $430 million was invested in Class B shares, compared to $220 million for Class A shares. Indeed, at all dates reflected in both prospectuses, the amounts invested in Class B shares in the funds substantially exceeded the amounts invested in Class A shares.

Of course, "a broker cannot rely upon a customer's investment objectives to justify a series of unsuitable recommendations that may comport with the customer's stated investment objectives but are nonetheless not suitable for the customer, given the customer's financial profile." Department of Enforcement v. Chase, No. C8A990081, 2001 NASD Discip. LEXIS 30, at *17-18 (N.A.C. Aug. 15, 2001). But here the weight of the evidence indicated that the customers, having received an accurate comparison of the advantages and disadvantages of Class A and Class B shares, elected to purchase Class B shares. Enforcement offered no evidence that Respondent failed to disclose the potential financial advantage of Class A shares in a timely and accurate manner, or that,

based upon the information that was available to him at the relevant time, the purchase of Class B shares was clearly against the customers' financial interest.

Under these circumstances, the Hearing Panel concluded that Enforcement failed to prove, by a preponderance of the evidence, that Respondent recommended the purchase of Class B shares without having a reasonable basis for believing they were suitable for the customers.

B. Failure to Amend Form U-4

1. Website Complaint

Article V, Section 2(c) of NASD's By-Laws provides: "Every application for registration filed with the NASD shall be kept current at all times by supplementary amendments …." It is well-established that the failure of a registered representative to update his or her Form U-4 as required by this provision is a violation of Rule 2110.

At the relevant time, Respondent was required to disclose on his Form U-4, among other things, any "investment-related, consumer-initiated, written complaint" that alleged he was involved in "sales practice violations" and that "contained a claim for compensatory damages of $5,000 or more (if no damage amount is alleged, the complaint must be reported unless the firm has made a good faith determination that the damages from the alleged conduct would be less than $5,000) …." (Complaint ¶ 39.)[9] Enforcement contends that this provision encompassed the complaint that was filed on NASD's website in KK's name in November 2002. There is no dispute that Respondent did not amend his Form U-4 to disclose that complaint.

[9] This provision of the Form U-4 was subsequently amended to delete the word "written," so that it now requires disclosure of "an investment-related, consumer-initiated complaint …." (CX 45 at 37.)

The Hearing Panel agrees that Respondent was required to disclose the website complaint. It was in writing and asserted that Respondent sold KK more than $600,000 in Fidelity Class B shares even though he knew that KK "had concerns regarding liquidity," and that he "never explained the difference in fees and charges between the Class B Shares that [KK] bought and other Classes that were available." Thus, it was plainly investment-related and involved sales practice violations, as those terms are defined in the Form U-4. Furthermore, although the complaint does not claim a specific amount of damages, it implies that KK suffered injury as a result of Respondent's actions, and Respondent did not testify or offer any evidence that the Firm made a good faith determination that KK's damages would be less than $5,000.

Respondent has claimed from the outset that he did not report the complaint because he believed that it came from KK's husband, WK, rather than KK, because: (1) KK had told him that WK was angry about the assistance and advice Respondent had given her; (2) he thought WK had written the earlier complaint (which Enforcement does not allege Respondent was required to report); and (3) he knew KK would not use some of the terminology in the complaint, such as "liquidity" and "breakpoint." And indeed in reviewing the complaint at the hearing, KK acknowledged that her husband helped her write the complaint and that "there are words here I do not understand." (Tr. 155.)

The Form U-4, however, required disclosure of a "consumer-initiated" complaint. KK testified that, although her lawyer suggested that she file a complaint on NASD's website and her husband helped her write it, she initiated the complaint. In any event, on its face the complaint came from KK, not WK or anyone else; without further inquiry, Respondent simply assumed it came from WK and decided on that basis not to report it.

The Panel concludes, however, that absent clear evidence that KK did not initiate the complaint—which Respondent did not have—he was required to report it on his Form U-4.

2. Wells Letter

Enforcement argues that Respondent also violated Rule 2110 by failing to update his Form U-4 to disclose NASD's investigation after he received the Wells letter from NASD staff in March 2004. There is no dispute that Respondent was required to report the letter, but Respondent and his wife testified credibly that they tried to update his Form U-4 and believed that they had been successful.

The Hearing Panel finds that Respondent made a good faith effort to amend his Form U-4 to disclose the Wells letter. It was the first time that the Respondent and his wife had used the Web CRD system to amend a Form U-4, and, as Enforcement's NASD staff witness explained, the amendment process is complex, so it is not too surprising that they were unsuccessful. But Respondent had an obligation to ensure that his Form U-4 was amended, and if he had checked Web CRD to confirm that his effort to file the amendment had been successful, he would have learned that his Form U-4 had not been amended, as required.

The Hearing Panel, therefore, concludes that Respondent violated Rule 2110 by failing to update his Form U-4 to disclose the Website complaint and the Wells letter. Under the circumstances presented, however, the Panel does not find Respondent's violations to be willful.[10]

[10] Although willfulness is not required to find a violation of Rule 2110, a willful failure to amend a Form U-4 could subject a person to "disqualification" under Article III, Section 4 of NASD's By-Laws. See Department of Enforcement v. Knight, No. C10020060, 2004 NASD Discip. LEXIS 5 (N.A.C. April 27, 2004).

IV. Sanctions

For late filing of an amendment to a Form U-4, NASD's Sanction Guidelines recommend a fine of $2,500 to $25,000, and for failure to file they recommend a fine of $2,500 to $50,000 and consideration of a suspension of five to 30 business days.[11] In setting specific sanctions, Adjudicators are directed to consider the nature and significance of the information at issue and whether the failure resulted in a statutorily disqualified individual being associated with a firm, as well as the general considerations applicable to all violations. NASD Sanction Guidelines at 6-7, 73 (2006).

In this case, neither the Website complaint nor the Wells letter was a disqualifying event. The complaint included serious allegations, but some of those allegations—such as that Respondent "never explained the difference in fees and charges between the Class B Shares that I bought and other Classes that were available"—were unquestionably false. And the Panel found that Respondent's failure to amend his Form U-4, while improper, was based upon a good faith belief that WK had filed the complaint, rather than KK. In addition, while the Wells letter also included serious allegations, the Panel found that Respondent made a good faith, but unsuccessful, attempt to amend his Form U-4 to disclose that he had received the letter. Under these circumstances, the Panel concluded that the appropriate sanction was a $5,000 fine. No suspension or censure is appropriate under the facts of this case.

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[11] For egregious violations, the Guidelines recommend a longer suspension of up to two years, or a bar, but this is not an egregious case.

V. Conclusion

Respondent is fined $5,000 for failing to timely amend his Form U-4, as alleged in causes five and six of the Complaint, in violation of Rule 2110. Causes one through four of the Complaint, alleging that Respondent recommended certain transactions to customers without having a reasonable basis for believing they were suitable, are dismissed. The fine shall be payable on a date set by NASD, but not less than 30 days after this decision becomes NASD's final disciplinary action in this matter.[12]

HEARING PANEL

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By: David M. FitzGerald
Hearing Officer

[12] The Hearing Panel has considered and rejects without discussion all other arguments of the parties. Under the circumstances, no costs are imposed.