NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. ERIK MATZ (CRD No. 2715303), Respondent.	Disciplinary Proceeding No. CLI050014 Hearing Officer-SNB **HEARING PANEL DECISION** February 20, 2007

Respondent is barred in all capacities for engaging in excessive trading and churning in customer accounts, in violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Rules 2310(a), 2120 and 2110.

Appearances

Vaishali Shetty, Esq. and Jon Batterman, Esq., Jericho, NY (Rory C. Flynn, Esq., Washington, DC, of Counsel), for the Department of Enforcement.

Michael Finkelstein, Esq., Bay Shore, NY, for Respondent.

DECISION

I. Procedural History

On May 31, 2005, the Department of Enforcement filed an Amended Complaint against Respondent Erik Matz ("Respondent") and three other respondents. The other respondents subsequently settled the claims against them. Respondent is charged with engaging in excessive trading and churning in the accounts of customers EH and MW, in violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Rules 2310(a), 2120 and 2110.

Respondent filed an Answer denying the charges and requesting a hearing. On June 27, 2006, the day before the hearing was scheduled to occur, Respondent filed a Motion to Postpone the Hearing. The Hearing Officer held an emergency pre-hearing conference on the same day. Respondent argued that he had a drug dependency that impaired his ability to prepare for, and participate in, his defense. Enforcement argued that Respondent was still in the industry, and should not be permitted to delay the hearing at the last minute. The Hearing Officer denied Respondent's Motion to Postpone the Hearing. The Hearing Officer noted that the allegations in the Complaint were serious, Respondent was still in the industry, and the medical records submitted with the Motion were ambiguous. The Hearing was held in New York, NY, on June 28 and 29, 2006, before a Hearing Panel that included a Hearing Officer, a former member of the District 10 Committee, and a former member of the District 8 Committee.[1] During the hearing, the Panel observed that Respondent was actively engaged and fully able to participate in the proceedings. Tr. 411-412.

II. Facts

A. Respondent

Respondent has been registered with NASD through a number of member firms since entering the securities industry in 1996. Tr. 413-415. He became registered with Aura Financial Services, Inc. ("Aura") in October 2002, and was registered there at the time of the hearing. CX-1.

[1] Enforcement offered Complainant's Exhibits "CX" 1-19, 25 and 29, which were admitted without objection. Citations to the Hearing transcript are cited as "Tr. _."

B. The EH Account

EH opened an account at Aura in approximately April 2002, when her registered representative of many years transferred there. Tr. 35-36. In August 2002, EH retired from her position as a special education teacher. Tr. 33. In September 2002, EH's broker left the securities industry.

In early October 2002, Respondent took over responsibility as EH's broker. At that time, EH's new account form reflected that EH was a single, 62-year-old school teacher with an annual income of $50,000 to $100,000, and a net worth of over $500,000.[2] CX-6; Tr. 37, 413, 437. EH's option agreement reflected an annual income of $80,000 and a net worth of $2.2 million. CX-6. Respondent learned from his initial conversations that EH was retired, so he knew that her income would be lower than indicated on her new account form, and would consist solely of social security payments and dividends. Tr. 43-44, 47, 144, 416. Nonetheless, he made no effort to update EH's account documentation to reflect this.

EH testified that the $2.2 million net worth reflected in her options agreement was inaccurate - she claimed that her net worth was approximately $1 million, largely consisting of her Aura account. Tr. 39, 41. EH does not recall discussing her financial situation with Respondent. Tr. 48-49. However, Respondent claimed that EH told him that, in addition to her Aura account, she had certificates of deposit and treasury bills amounting to over $1 million. Tr. 433-434. This is contradicted EH's tax returns, which do not reflect interest income from the purported certificates of deposit and treasury bills. CX-4. After considering and giving weight to the contradictory evidence, the Panel

[2] EH's tax returns reflected an annual income of approximately $43,000, $59,000 and $47,000 for 2000, 2001 and 2002, respectively. CX-4.

discredits Respondent's claim that EH claimed to have an additional $1 million outside her Aura account. That said, the Panel does not rule out the possibility that Respondent believed that EH had $2.2 million in assets based upon what was reflected on her options agreement.

Respondent does not dispute that EH's investment objective was "capital appreciation," which he acknowledged is a "fairly conservative investment objective." Tr. 45, 423; Answer, paragraph 7. EH testified that Respondent did not discuss investment strategies with her. Tr. 144. However, Respondent claimed that, after discussions, EH said she wanted to engage in speculation and short term trading. Tr. 425. The Panel did not credit Respondent's claim, because it was inconsistent with the credible testimony of EH that her investment objectives never changed - she wanted to "generate some income without having to touch the principal." Tr. 45. Additionally, Respondent acknowledged that he did not update her account documentation – an omission he explained by claiming that he instead took contemporaneous notes reflecting EH's changed investment strategy, which he gave to Aura's Compliance Department after EH complained about her account. Tr. 425. However, these notes never materialized. Tr. 425-427. Additionally, the Panel considered that Respondent made the same, self-serving claim with respect to MW's account discussed below, and MW credibly refuted it.

As of September 30, 2002, the market value of EH's account was $1.112 million, and consisted primarily of approximately $930,000 in Fifth Third Bancorp securities ("FITB") that she inherited from her parents. CX-7, p. C 0145; Tr. 72, 97, 328-329. Once Respondent took over as the broker, there was a dramatic change in the level and nature of trading in EH's account. Respondent acknowledged this higher level of activity, and

indicated that EH's account was his most actively traded account at the time. Tr. 420-421. In particular, in the last weeks of October alone, Respondent purchased almost $3.4 million in equities, and sold over $3.5 million.[3] CX-7. In November, Respondent purchased $1 million in equities and sold $800,000. CX-7. In October and November, 2002, Respondent executed 138 transactions.[4] The average monthly equity in the account from October through December was approximately $945,000. CX-9. During the same time, the cost-to-equity ratio – the percentage EH would have to earn to break even – was 26%, or 104% on an annualized basis.[5] CX-9.

Respondent does not dispute that he recommended the trading in the account, which he characterized as a short-term trading strategy. Tr. 431-432. Respondent told EH that he could double the value of her account, and EH agreed to all of Respondent's recommendations. Tr. 51, 149, 438-439.

In less than three months, Respondent generated over $240,000 in gross commissions, $60,000 of which he received as compensation. CX-9; Tr. 282. During this period, the account incurred approximately $2,700 in margin interest. CX-7. Moreover, Respondent took large mark-ups and mark-downs on trades of highly liquid securities.

---

[3] There is no dispute that in their initial conversations, Respondent recommended that EH sell a significant portion of her holdings in FITB. EH acknowledged that she "had too many eggs in one basket," and she authorized the sale of some FITB stock, although neither Respondent nor EH indicated, during their discussions, how many shares were to be sold. Tr. 50, 142-143. In the next weeks, Respondent sold the bulk of EH's FITB holdings, and this action is not criticized by EH or Enforcement.

[4] While Respondent claims that some of these were partial executions of block transactions, this was not readily apparent from record evidence, and Respondent did not cite any examples of this in EH's account. Tr. 419.

[5] The cost-to-equity ratio "is sometimes expressed as the 'break-even cost factor.' The phrases refer to identical calculations. ... This calculation represents the percentage of return on the customer's average net equity needed to pay broker/dealer commissions and other expenses, such as margin interest. Put another way, because of the transaction costs related to trading, the account would need to appreciate that amount to break even." DBCC v. Pinchas, 1998 NASD Discip. LEXIS 59 at n.7 (NAC June 12, 1998), aff'd Exch. Act Rel. No. 41816, 1999 SEC LEXIS 1754 (Sept. 1, 1999).

For example, Respondent took a mark down of over $14,000 on 10,000 shares of Verizon – a mark-down that Respondent was unable to justify when confronted with it. CX-8 p. 330; Tr. 451-452.

In November 2002, EH became concerned with the large volume of confirmations and activity reflected in her account statements. She discussed this concern with her cousin, MW, who also had an account with Respondent at Aura. Tr. 56-58. MW told EH that their former broker suggested that they close their accounts with Respondent, before the accounts were "bled dry." Tr. 186-187. EH agreed, and on December 6, 2002, EH sent Aura a letter requesting that the account be frozen. CX-5. EH ultimately instituted arbitration proceedings against, among others, Respondent and Aura, culminating in a settlement of her claims for $300,000.

C. The MW Account

EH's cousin, MW, also opened an account at Aura when her registered representative transferred there in early 2002. CX-14; Tr. 152-153. In early October 2002, Respondent took over responsibility as MW's broker. At that time, MW's new account form reflected that she was a 63-year-old hairdresser with an annual income of $25,000 to $50,000[6] and a net worth of $100,000 to $250,000. CX-14; Tr. 155-156. Consistent with this, MW's options agreement, completed at the same time, indicated an annual income of $30,000, and liquid net worth of $150,000. CX-14; Tr. 158-159. MW's new account form indicated an investment objective of "capital appreciation," and her options agreement listed "dividend and premium income" as her first priority. CX-14;

[6] MW's tax returns reflected an annual income of approximately $40,000, $39,000 and $22,000 for 2000, 2001 and 2002, respectively. CX-18.

Tr. 161, 163. MW testified "I didn't want much risk, as little risk as possible, but I wanted to make some money." Tr. 155.

Again, Respondent does not dispute that MW's investment objective was "capital appreciation" which he acknowledged is a "fairly conservative investment objective." Tr. 423. However, Respondent claimed that, like EH, MW agreed with Respondent's recommendation to engage in speculation and short term trading. Tr. 425. Again, Respondent acknowledged that he did not update her account documentation to reflect this change in strategy. Rather, he again claimed that he took contemporaneous notes, which he gave to Aura's Compliance Department. Tr. 425-427. For the reasons noted above, however, the Panel did not credit Respondent's version of events.

Respondent never discussed particular buys and sells in MW's account. MW recalls that Respondent told her that he could increase the value of her account from $130,000 to $170,000 by the end of the year, but she should not be disappointed if he only got it up to $150,000. Tr. 171-172. Later, when MW asked about the significant activity in the account, he told her "that's the way you make money." Tr. 170. Respondent acknowledges that he recommended the trading in MW's account, and MW acquiesced in Respondent's recommendations. Tr. 173, 431-432, 438-439.

Respondent concedes that he increased the trading activity in MW's account. Tr. 422. Although MW's account, with an average monthly equity of approximately $130,000, was much smaller than EH's account, from October 15 through October 31, 2002, Respondent purchased $525,000 in equities, and sold almost $500,000. CX-15 p. C0938; CX-17. In a little less than a month, Respondent executed 34 transactions in the account. CX-17. For the period October 18, 2002, through November 14, 2002, the

turnover ratio for these transactions was 3.95, or 23.71 on an annualized basis.[7] These transactions had a cost-to-equity ratio of 25%, or 153% on an annualized basis. In less than three months, Respondent generated approximately $33,000 in gross commissions on MW's account, $8,000 of which he received as compensation. Tr. 422-423.

During this time, MW's husband was seriously ill, and was in and out of the hospital. MW told Respondent about her husband's illness. Tr. 169. At the Hearing, Respondent claimed he was unaware of it, but when confronted with his on-the-record-testimony where he acknowledged his awareness, he claimed, incredibly, that there was a difference between "sick" and "ill." Tr. 419.

On November 19, 2002, MW received a call from her prior broker, who told her that Respondent had a disciplinary history and would "bleed her dry," and that she should transfer her account. On the same day, she contacted Aura and froze her account. CX-13; Tr. 186-187. Along with her cousin EH, MW ultimately instituted arbitration proceedings against, among others, Respondent and Aura, culminating in a settlement of her claims for $60,000. Tr. 190.

III. Violations

The Complaint charges that Respondent violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Rules 2310(a), 2120 and 2110 by engaging in excessive trading and churning in EH's and MW's accounts.

[7] Turnover ratio is a well-accepted tool in evaluating the activity level of a securities account. "The turnover ratio is calculated by applying the 'Looper formula,' named after In re Looper & Co., 38 S.E.C. 294 (1958), which divides the total cost of purchases made during a given period by the average monthly investment. … The turnover ratio is computed 'by dividing the aggregate amount of the purchases by the average cumulative monthly investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration.' A modified Looper formula divides the total cost of purchases by the average monthly equity." Pinchas, 1998 NASD Discip. LEXIS 59 at n.6 (citations omitted).

Rule 2110 requires registered representatives to "observe high standards of commercial honor and just and equitable principles of trade." Rule 2310(a) requires that, in recommending the purchase or sale of a security, an associated person must have a reasonable basis for believing that the recommendation is suitable for the customer, based on the facts disclosed by the customer as to his or her other security holdings and his or her financial situation and needs.[8] In other words, recommendations must be consistent with the customer's best interests. Wendell D. Belden, Exch. Act Rel. No. 47,859, 2003 SEC LEXIS 1154, at *11 (May 14, 2003). Excessive trading, by itself, "can violate NASD suitability standards by representing an unsuitable frequency of trading." Pinchas, 1999 SEC LEXIS 1754 at *22 (Sept. 1, 1999).

To establish excessive trading, Enforcement must prove two elements. First, Enforcement must show that Respondent had control over trading in the account. Second, Enforcement must show that the level of activity in the account was inconsistent with the customers' objectives and financial situation. Pinchas, 1999 SEC LEXIS 1754, at **11–12 (Sept. 1, 1999).

Where a third element is present – intent to defraud or reckless disregard for the client's interests, *i.e.*, scienter – the misconduct also constitutes churning. J. Stephen Stout, Exch. Act. Rel. No. 43410, 2000 SEC LEXIS 2119, at *50 (Oct. 4, 2000). Churning violates Section 10(b) of the Exchange Act, which prohibits the use of "any manipulative or deceptive act or practice" in connection with the purchase or sale of a security, and Exchange Act rule 10b-5, which forbids "any device, scheme, or artifice to

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

defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." Churning also violates Rule 2120.

As discussed below, the panel found all three elements – control, excessive trading, and scienter – to be present in this case.

Control may be established where a customer expressly agrees to give the broker discretion to trade the account, or absent that, where the broker exercises de facto control of the account. DBCC v. Gates, No. C05930020, 1994 NASD Discip. LEXIS 190, at *24 (April 5, 1999). De facto control may be established "where the customer habitually follows the advice of the broker." J. Stephen Stout, 2000 SEC LEXIS 2119, at *75 (Oct. 4, 2000). In this case, Respondent initiated all the trading in the EH and MW accounts, and at least with respect to MW, contacted her only after he placed the trades, if at all. In each case, EH and MW acquiesced in Respondent's trading, further indicating Respondent's control over the accounts.

There is no single test to determine excessive trading. Rather, there are a number of factors, such as the turnover ratio, the cost-to-equity ratio, and the number and frequency of trades in an account, which may be considered. See Department of Enforcement v. Gliksman, No. C02960039, 1999 NASD Discip. LEXIS 12 at *25, (NAC March 31, 1999), aff'd, Exch. Act Rel. No. 42,255, 1999 SEC LEXIS 2685 (Dec. 20, 1999). Generally, excessive trading is indicated by a turnover rate in excess of six. David Wong, Exch. Act Rel. No. 45,426, 2002 SEC LEXIS 339, at *14, n.18 (Feb. 8, 2002); Bucchieri, Exch. Act Rel. No. 37,218, 1996 SEC LEXIS 1331, at *11, n.11 (May 14, 1996), citing Mihara v. Dean Witter & Co., Inc., 619 F.2d 814, 821 (9th Cir. 1980).

Excessive trading is also generally indicated where there is an annualized cost-to-equity ratio in excess of 20%. Pinchas, 1999 SEC LEXIS 1754, at *18 (Sept. 1, 1999).

In this case, EH's account had an annualized cost-to-equity ratio of 104%.[9] MW's account had an annualized turnover ratio of 23.71, and an annualized cost-to-equity ratio of 153%. These levels are far above the levels generally indicative of excessive trading. This is underscored, when the level of trading is measured against the conservative investment objectives of these two elderly investors with moderate, fixed incomes. Given these levels of activity, it is irrelevant whether, for example, EH had $1 million in net assets, or $2.2 million in net assets, as Respondent claimed.

Although the Panel rejected Respondent's assertion that EH and MW changed their objectives and wanted to speculate, even if they had, "a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile." Stein, 2001, NASD Discip. LEXIS 38 at *10 (NAC Dec. 3, 2001), citing Pinchas, 1999 SEC LEXIS 1754, at *22 (Sept. 1, 1999) (a customer's desire to "double her money" does not relieve the registered representative of the duty to recommend only suitable investments).

Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n.12 (1976). To prove scienter there must be a showing that the respondent acted intentionally or recklessly. See M. Rimson & Co., Inc., Initial Decision Release No. 106, 1997 SEC LEXIS 486, at *95 (Feb. 25, 1997); Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1067 (5th Cir. 1994),

[9] Enforcement did not calculate a turnover rate for EH's account, because there was options trading that would distort the calculation.

1994 U.S. App. LEXIS 3326 at *14 (1994). Recklessness is evident when the conduct "presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991). Scienter is a mental state embracing intent to deceive, manipulate or defraud. Scienter can be inferred from the circumstances. Brian A. Schmidt, Exch. Act. Rel. No. 45330, 2002 SEC LEXIS 180, at *31 (Jan. 24, 2002). Here, the trading activity in EH's and MW's accounts was dramatically higher than the levels sufficient to find excessive trading. Moreover, Respondent himself could not justify the level of mark-ups when confronted with it. Finally, in less than three months Respondent generated almost $280,000 in commissions on the two accounts. See David Wong, 2002 SEC LEXIS 339 at *14-15 (Feb. 8, 2002) (scienter may be inferred from the amount of commissions charged).

Respondent claimed, and the Panel agrees, that Enforcement's loss analysis presented at the hearing dramatically overstated the actual losses in the EH and MW accounts. Respondent also claimed that EH and MW were ultimately unharmed, because they were made whole through their arbitration actions. However, Enforcement's errors in calculating customer losses do not impact its claim of violative conduct, because a violation may occur regardless of the ultimate condition of the client's portfolio. See Nesbit v. McNeil, 896 F.2d 380, 1990 U.S. App. LEXIS 2062, at *22 (9th Cir. 1990); Department of Enforcement. v. Castle Securities Corp., No. C3A010036, 2004 NASD Discip. LEXIS 2347 at *19 (NAC Feb. 19, 2004) ("the existence of churning does not turn on whether the customer lost money. The effect of churning is to reduce the customer's return on her investment by

increasing the commissions generated by the account. …An account may be churned even if the customer shows a profit on the excessive trading"). Similarly, a customer's recovery of losses from a broker through arbitration has no impact upon Enforcement's ability to take disciplinary action against that broker for his misconduct.

Accordingly, the Hearing Panel finds that Respondent engaged in excessive trading and churning in customer accounts, and that Respondent therefore violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Rules 2310(a), 2120 and 2110.

IV. Sanctions

The recommended sanctions for excessive trading and churning are a fine of $2,500 to $75,000 and a suspension of 10 days to one year, or, in egregious cases, a bar. NASD Sanction Guidelines (2006 ed.) ("Guidelines") at p. 82.

The Panel applied the factors or "Principal Considerations" suggested in the Guidelines and found that Respondent's conduct was egregious and warranted a bar.

In making this determination, the Panel considered that Respondent had a disciplinary history that included excessive and unauthorized trading, as well as the exercise of discretion without written authority. The Panel also considered that Respondent acted with scienter, and he did not accept responsibility for his misconduct. Moreover, Respondent engaged in excessive trading for personal gain, generating $277,000 in gross commissions in less than three months, and pocketing $68,000 personally. Finally, the Panel considered that Respondent's customers were elderly women who trusted Respondent, and he abused that trust.

V. Conclusion

For engaging in excessive trading and churning in customer accounts, in violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Rules 2310(a), 2120 and 2110, Respondent is barred. In addition, Respondent is ordered to pay costs in the amount of $4,531.81, which includes an administrative fee of $750 and Hearing transcript costs of $3,781.81.[10]

These sanctions shall become effective on a date set by the NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of the NASD, except that the bar shall become effective immediately if this Decision becomes the final disciplinary action of NASD.

HEARING PANEL

_____

By: Sara Nelson Bloom
Hearing Officer

Copies to: Erik Matz *(via overnight and first-class mail)*
Michael Finkelstein, Esq. (*via facsimile and first-class mail*)
Vaishali Shetty, Esq. (*via electronic and first-class mail*)
Jon Batterman, Esq. (*via electronic and first-class mail*)
Rory C. Flynn, Esq. (*via electronic mail*)
Mark P. Dauer, Esq. *(via electronic mail)*

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