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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. CAF040079 Hearing Officer—Andrew H. Perkins **EXTENDED HEARING PANEL DECISION** April 25, 2008

The Hearing Panel dismissed the Complaint. The Department of Enforcement failed to show by a preponderance of the evidence that the Respondent misrepresented or omitted material facts in connection with sales of Enron bonds, in violation of Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, and NASD Conduct Rules 2120 and 2110; or that the Respondent failed to implement a supervisory system and procedures reasonably designed to achieve compliance with applicable securities laws and regulations and NASD Conduct Rules, in violation of NASD Conduct Rules 3010 and 2110.

Appearances

For the Complainant: Rory C. Flynn, David R. Sonnenberg, and Robin W. Sardegna, FINRA, DEPARTMENT OF ENFORCEMENT, Washington, DC.

For the Respondent: Lionel E. Pashkoff, Robert M. Bernstein, and Howard Wilson, PROSKAUER ROSE LLP, Washington, DC, and New York, NY.

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DECISION

I. INTRODUCTION

On November 8, 2004, the Department of Enforcement ("Enforcement") filed a four-count Complaint against [Respondent] ("[Respondent]" or the "Firm"), a FINRA member firm,[1] alleging sales practices and supervisory violations relating to sales of Enron Corporation ("Enron") bonds by the Firm's registered representatives during the one-month period immediately preceding Enron's bankruptcy filing for Chapter 11 protection on December 2, 2001.

The first two causes of action allege that Respondent, acting through approximately 200 of its registered representatives, misstated and omitted material facts in connection with the offer and sale of Enron bonds to more than 800 customers between October 29, 2001, and November 27, 2001.[2] The Complaint alleges that Respondent gave investors false information about the safety of Enron bonds and failed to disclose material negative information pertaining to the bonds' default risk, including the fact that Moody's Investor Services ("Moody's") and Standard & Poor's Corporation ("Standard & Poor's") had downgraded the bonds' credit ratings and placed the bonds under review for possible further downgrades. The First Cause of Action alleges that Respondent thereby defrauded customers, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), SEC Rule 10b-5, and NASD Conduct Rules 2120 and 2110. The Second Cause of Action alternatively alleges that Respondent failed to

[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA shall include, by reference and where appropriate, references to NASD. FINRA's rules, which include NASD Conduct and Procedural Rules, are available at www.finra.org/rules.

[2] Compl. ¶¶ 1-2.

observe high standards of commercial honor and just and equitable principles of trade, in violation of NASD Conduct Rule 2110.

The remaining two causes of action allege supervisory violations. In the Third Cause of Action, as supplemented by Enforcement's Bill of Particulars, Enforcement claims that Respondent failed to establish and maintain a system to supervise the sales activities of its registered representatives that was reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Conduct Rules, in violation of NASD Conduct Rules 3010(a) and 2110. The Fourth Cause of Action, as supplemented by the Bill of Particulars, alleges that Respondent failed to establish, maintain, and enforce written procedures to supervise the types of business in which the Firm engaged and to supervise the activities of its registered representatives that were reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Conduct Rules, in violation of NASD Conduct Rules 3010(a)(1) and 2110. Specifically, the Complaint and Bill of Particulars claim that the Firm's written procedures were inadequate because they did not address the "oversight of the acquisition of the [Enron] bonds or of the process by which they were made available to registered representatives at a high sales credit."[3]

II. PROCEDURAL HISTORY

FINRA instituted the investigation that led to the filing of the Complaint against Respondent in the second quarter of 2003 shortly after FINRA received a complaint from one of Respondent's customers concerning the customer's purchase of Enron bonds.[4] After receiving the complaint, FINRA requested information from Respondent about any other customer

[3] Bill of Particulars, at 7-8.

[4] Tr. 840, 844.

complaints it had received regarding Enron bond sales. In response, Respondent provided a list of 20 to 30 customer complaints. FINRA staff then began a formal investigation into the sale of Enron bonds by Respondent's sales force.[5]

Enforcement filed the Complaint on November 8, 2004. Respondent filed its Answer on December 23, 2004. Respondent denied any wrongdoing and requested a hearing.

On May 9, 2005, Respondent moved to dismiss the fraud charges (First Cause of Action) and Enforcement's claim for restitution.[6] The Hearing Officer denied the motion on March 13, 2006. The Hearing Officer held that the allegations of scienter in the Complaint were adequate and found that there were material facts in dispute regarding the sales credits Respondent offered its sales force on the sales of Enron bonds. The Hearing Officer therefore concluded that Respondent was not entitled to summary disposition of the fraud charges as a matter of law. The Hearing Officer further concluded that restitution was an appropriate and well-recognized sanction in FINRA disciplinary proceedings. Accordingly, the Hearing Officer rejected Respondent's arguments that Enforcement's claim should be dismissed.

The hearing was held in three locations (Chicago, IL; Rockville, MD; and New York, NY) over 24 days starting in May 2006 and ending in August 2007.[7] The parties filed post-hearing briefs in October 2007.

The Extended Hearing Panel that heard the case was comprised of a Hearing Officer and two former members of the District 10 Committee, one of whom also is a former member of NASD's Board of Governors. On September 24, 2007, pursuant to NASD Procedural Rule

[5] Tr. 844-45.

[6] Respondent's Mot. Summ. Disp.

[7] The transcript of the hearing is cited as "Tr." followed by the page number. Enforcement's exhibits are labeled with the prefix "CX," and Respondent's exhibits are labeled with the prefix "RX."

9231(e), the Hearing Officer was replaced due to her incapacity. Pursuant to Procedural Rule 9231(e)(1), the replacement Hearing Officer did not participate in the resolution of the issues in this proceeding because, unlike the other two panelists, the replacement Hearing Officer did not have the opportunity to observe the witnesses testify, and he therefore could not make vital credibility determinations without recalling each witness, which would have resulted in undue delay.

III. FACTS

Between October 29 and November 27, 2001, 255 of Respondent's registered representatives in 98 branch offices sold 18,311 Enron bonds to 1132 customers.[8] All were solicited sales. The bonds had maturities of 9 and 18 months and were rated investment grade by both Moody's and Standard & Poor's. Three series of bonds were involved: (i) CUSIP 293561BL9, which was issued on or about August 7, 1997, and matured on August 1, 2002, with a coupon of 6.5%; (ii) CUSIP 293561AF3, which was issued on or about June 22, 1998, and matured on June 15, 2003, with a coupon of 9.875%; and (iii) CUSIP 293561CB0, which was issued on or about June 6, 2000, and matured on June 15, 2003, with a coupon of 7.875%.[9]

Enforcement's central contention regarding the sales of Enron bonds was that Respondent used "inflated" gross sales credits set by its Fixed Income Department to induce the Firm's sales force to mount a nationwide sales campaign to sell the bonds to Respondent's customers. In essence, Enforcement portrayed Respondent's Fixed Income Department as a high-pressure sales operation that pushed worthless or nearly worthless securities onto the Firm's customer base. Enforcement further contended that the high gross sales credits caused

[8] CX14.017; CX14.018.

[9] Tr. 845-46.

many registered representatives to resort to material omissions and misstatements when recommending the bonds, in violation of the antifraud provisions of the securities laws, rules, and regulations, as well as FINRA's prohibition against employing unjust and inequitable practices in connection with the sales of securities. In particular, Enforcement contended that Respondent's registered representatives should have advised their customers that the risk of default was higher than what the bonds' investment-grade rating signified.

For the reasons discussed below, the Hearing Panel found that Enforcement failed to prove these allegations by a preponderance of the evidence. In particular, the Hearing Panel found no evidence that Respondent initiated a nationwide fraudulent sales campaign to sell Enron bonds or that it engaged in other wrongful misconduct in connection with the sales of Enron bonds. Accordingly, the Hearing Panel dismissed these charges.

Enforcement also contended that the fraudulent sales went unchecked because Respondent did not have an adequate supervisory system and procedures. The Hearing Panel dismissed these charges as well. Enforcement failed to show that Respondent's system and procedures were not reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Conduct Rules.

A. Respondent and the Firm's Fixed Income Department

Respondent and its predecessor, ["PF"], has been a registered broker-dealer and FINRA member since 1971.[10] Respondent acquired PF on December 1, 1999.

During the relevant period, Respondent was a full service broker-dealer with about 1200 registered representatives in about 350 offices.[11] Respondent's principal line of business was

[10] Tr. 847; CX01 (excerpt from Respondent's Central Registration Depository record).

[11] Tr. 2963.

retail equity sales. Fixed income products represented a minimal amount of Respondent's business measured by either total revenue or volume of transactions. During the relevant period, Respondent processed 150 to 200 fixed income transactions per day compared to between 8000 and 10,000 equity trades.[12] The Fixed Income Department was not operated as a profit center; it serviced registered representatives who needed fixed income products to meet customer needs.[13] The Fixed Income Department did not communicate directly with the Firm's customers.

Respondent's Fixed Income Department consisted of about 15 employees, one of whom covered corporate bonds.[14] JF managed the department, and each of the department's traders reported to him.[15] JF was an experienced bond trader and supervisor with more than 20 years in the securities industry.[16] JF reported directly to TF, Respondent's Chief Operating Officer.[17] The Firm's legal, compliance, and research departments also reported to TF throughout the fourth quarter of 2001.[18]

MK was the department's sole corporate bond trader.[19] MK started his career in the securities industry with PF in 1996 as an assistant in the Fixed Income Department. In 1998, he was promoted to the position of trader and assigned to the Corporate Bond Desk.[20]

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[12] Tr. 2038-39, 2964. Moreover, approximately half of the fixed income transactions involved municipal bond sales.

[13] Tr. 2033, 2040.

[14] Tr. 2038, 2182-83.

[15] Tr. 1846, 1850.

[16] Tr. 2043-44. JF has no prior disciplinary history.

[17] Tr. 1846, 2448-49. TF had been the General Counsel for PF and its parent company. Tr. 2927. When Respondent acquired PF, TF assumed the role of Chief Operating Officer. TF held that position until he left Respondent in April 2004. *See* Tr. 2374-75.

[18] Tr. 2376-77.

[19] Tr. 1853, 2181.

[20] Tr. 2179-80. MK has no prior disciplinary history.

MK had four primary areas of responsibility. First, he offered investment-grade bonds with a variety of maturity ranges to the Firm's registered representatives. MK decided which corporate bonds Respondent would purchase, as well as the amount and price at which Respondent would purchase bonds and resell them to customers. He also set the sales credits for the bonds.[21] Second, MK provided bids and offers for issues not offered on the Fixed Income Department's bond-offering screen. Third, MK posted significant news about selected issues and issuers on the ZIA System and its StoryTeller feature ("StoryTeller"),[22] which supplemented the market news available to Respondent's registered representatives through the Firm's intranet.[23] Fourth, MK had a number of clerical responsibilities, such as manually entering order tickets.[24] MK also spent a substantial amount of time answering questions from the Firm's registered representatives.[25]

1. Respondent Limited Its Registered Representatives to Recommendations of Investment-Grade Bonds

Given the limited role and size of the Fixed Income Department, Respondent restricted its corporate bond offerings to widely traded bonds[26] rated "investment grade" by at least two credit rating agencies designated by the SEC as Nationally Recognized Statistical Rating Organizations or NRSROs.[27]

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[21] Tr. 1915, 2205.

[22] MK also used e-mail to distribute information regarding the corporate bonds. Tr. 2201.

[23] Tr. 2199. Respondent switched from the AS-400 System to the ZIA System in October 2001. The ZIA System had a greater capability to display news.

[24] Tr. 2184-85.

[25] Tr. 2206.

[26] Tr. 2380-81.

[27] The term "NRSRO" was originally adopted by the Commission in 1975 solely for determining capital charges on different grades of debt securities under the Net Capital Rule. The requirement that the credit rating agency be "nationally recognized" was designed to ensure that its ratings were credible and

NRSROs provide contract services to issuers to rate their securities.[28] The rating reflects the NRSRO's expert opinion of the underlying financial strength or creditworthiness of the security. The rating takes into consideration the risk of default, "which refers to likelihood of payment—the capacity *and* willingness of the obligor to meet its financial commitment on an obligation in accordance with the terms of the obligation."[29] As the ratings are designed to grade the credit quality of obligations, they do not forecast future trends in the market price of the obligations.[30]

In broad terms, the NRSROs classify bonds into two categories. The term "investment grade" [31] refers to the top four general rating grades and signifies that a bond so rated has a lower default risk over the life of the issue than one assigned a rating of "speculative grade." Even bonds carrying the lowest investment-grade rating have a *de minimis* historical default rate of less than one-third of one percent.[32] "This separation [between investment- and speculative-

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reasonably relied upon by the marketplace. Currently, NRSRO ratings are widely used for distinguishing among grades of creditworthiness in federal and state legislation, rules issued by financial and other regulators, and even in some foreign regulations. *See* SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (Jan. 2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf.

[28] RX-S, at 5 (Respondent's Expert Rep't).

[29] CX07.003, at 9 (Standard & Poor's "Corporate Ratings Criteria" (2000)). *See also* CX07.001, at 12 (Moody's "Rating Symbols & Definitions" (Aug. 2004)).

[30] CX07.001, at 9 (Moody's "Rating Symbols & Definitions" (Aug. 2004)).

[31] "The term 'investment grade' was originally used by various regulatory bodies to connote obligations eligible for investment by institutions such as banks, insurance companies, and savings and loan associations. Over time, this term gained widespread usage throughout the investment community." A speculative grade bond sometimes may be referred to as a high-yield or "junk" bond. The term "junk bond," however, does not signify greater risk than its designated speculative rating; it "is merely a more irreverent expression for this category of more risky debt." CX07.003, at 11 (Standard & Poor's "Corporate Ratings Criteria" (2000)).

[32] RX-S, at 8 (Respondent's Expert Rep't); CX07.003, at 11 (Standard & Poor's "Corporate Ratings Criteria" (2000)).

grade securities] has been extremely important since bank and thrift regulators have allowed their institutions to own only investment-grade bonds."[33] Other financial institutions, such as insurance companies, pension funds, and investment companies, also have limits based on the distinction between investment- and speculative-grade bonds, and the ratings are incorporated into a number of formal securities industry regulations.

As a matter of general practice, Respondent relied on Moody's and Standard & Poor's, which generally designate ratings of long-term debt through an alphabetical combination of lower- and upper-case letters. Standard & Poor's uses the designators AAA, AA, A, and BBB for investment grade; and BB, B, CCC, CC, C, and D for speculative-grade rankings. Moody's long-term rating designators are Aaa, Aa, A, Baa for investment grade; and Ba, B, Caa, Ca, and C for speculative grade. Moody's and Standard & Poor's also often attach modifiers to the grades to further distinguish and rank ratings within each generic classification. Standard & Poor's generally uses pluses and minuses to modify its grades, while Moody's generally uses three numerical modifiers, with "1" indicating that a credit falls in the higher end of the generic rating category, "2" indicating mid-range, and "3" indicating the lower end of the ranking.[34]

In addition to bond ratings, Moody's and Standard & Poor's provide opinions and information regarding possible rating changes. Both provide "rating outlooks," which are opinions of the likely direction of a rating in the medium to long term.[35] A rating outlook takes into account trends or risks with less certain implications for credit quality than the factors incorporated into the credit rating. A rating outlook is expressed generally as positive, negative,

[33] CX07.003, at 5-6 (Standard & Poor's "Corporate Ratings Criteria" (2000)).

[34] RX-S, at 5-6 (Respondent's Expert Rep't); CX07.003, at 9-10 (Standard & Poor's "Corporate Ratings Criteria" (2000)); CX07.001, at 12 (Moody's "Rating Symbols & Definitions" (Aug. 2004)).

[35] CX07.003, at 11-12 (Standard & Poor's "Corporate Ratings Criteria" (2000)); CX07.001, at 42 (Moody's "Rating Symbols & Definitions" (Aug. 2004)).

or neutral. A "negative" credit outlook indicates that a rating may be lowered, but it "is not necessarily a precursor of a rating change.…"[36] Rating outlooks are not incorporated into a bond's rating and are not accorded consideration equal with the rating by financial institutions and regulators.

Moody's and Standard & Poor's also provide contract services to indicate when a rating is under review. Moody's service is called "Watchlist," and Standard & Poor's is called "CreditWatch."[37] Generally, a bond is placed on these lists when an event triggers the need for additional information that might result in a change in a bond's rating. But a listing does not mean that a rating change is inevitable.[38]

The rationale underlying Respondent's policy to limit its fixed-income offerings to securities rated "investment grade" by two NRSROs was that the corporate bond desk did not have its own research department.[39] Pursuant to the policy, in the event an approved corporate bond was no longer rated investment grade by two NRSROs, Respondent removed the issue from its list of approved securities.[40] If a bond were to be removed from the approved list of securities, Respondent's registered representatives could no longer recommend the security to their customers. Respondent sold bonds without an investment-grade rating only if a customer initiated the transaction, and, in such a case, the registered representative received no compensation for the sale.[41]

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[36] CX07.003, at 12 (Standard & Poor's "Corporate Ratings Criteria" (2000)).

[37] *Id.* at 11-12; CX07.001, at 42 (Moody's "Rating Symbols & Definitions" (Aug. 2004)).

[38] CX07.003, at 12 (Standard & Poor's "Corporate Ratings Criteria" (2000)).

[39] Tr. 1862-63, 2193.

[40] Tr. 2267. The Fixed Income Department offered approximately 100 different issues at any given time. Tr. 2350-51.

[41] Tr. 2052.

At all times relevant to this proceeding, both Moody's and Standard & Poor's rated the Enron bonds investment grade.[42] Moody's debt rating for Enron had been Baa1 since March 2000. On October 29, 2001, Moody's lowered Enron's rating to Baa2 and placed Enron on its Watchlist for possible further downgrade. Standard & Poor's had rated Enron BBB+ since December 1995. On November 1, 2001, it lowered Enron's credit rating from BBB+ to BBB and placed Enron on negative CreditWatch.

2. Display of Approved Corporate Bonds

Respondent made the bonds on its approved list available to its sales force by posting them on the bond-offering screen of the Firm's AS-400 System and, later, on its ZIA System. The bond-offering screen listed a mix of readily available issues, as well as issues Respondent had already taken into inventory.[43] The Firm's registered representatives could not tell from the screen whether the displayed issues were in inventory or not.[44]

The bond-offering screen was accessible to Respondent's sales force at their desktop computer terminals.[45] It set forth the basic facts for the sale of a corporate bond, including the name of the issuer; the price of the bond; the yield; the maturity date; and the bond's rating.[46] Unlike many firms at the time, Respondent did not publish sales credit information with the bonds' listings.[47] KM, Respondent's Compliance Director, testified that he had sales credit

[42] The third NRSRO, Fitch, Inc. ("Fitch"), also maintained an investment-grade rating for the Enron bonds throughout the relevant period. The Enron bonds did not lose their investment-grade rating until November 28, 2001, just four days before Enron filed for bankruptcy.

[43] Tr. 2048.

[44] Tr. 2048.

[45] Tr. 1877.

[46] Tr. 1878-80, 2208.

[47] Tr. 2898-99.

information removed from the bond-offering screen before the relevant period to lessen any possible influence it could have on the registered representatives' recommendations.[48] In order to see sales credit information on a specific bond, the registered representatives had to use the Firm's bond calculator screen, which displayed a code that represented the assigned sales credit.[49]

MK's authority to purchase corporate bonds was subject to position limits. He needed JF's prior approval for a purchase of any one issue with a principal value of $1 million or more.[50] MK also had an overall limit on the amount of capital he could invest. His overall position limit was ten days' trailing volume or $10 million.[51] MK typically tried to maintain Respondent's net position for a particular issue below $1 million by taking both long and short positions in the security.[52] JF supervised MK's compliance with Respondent's position limits.[53] There is no evidence or allegation that MK violated any of Respondent's internal procedures or guidelines in his handling of the Enron bonds.

3. Sales Credits and Payouts

According to the parties' experts, MK set and allocated gross sales credits for bond sales in accordance with widely employed industry practice. Broker-dealers use a "gross sales credit" to represent an estimate of the gross profit derived from bond sales. Generally, broker-dealers take into account a variety of factors when setting gross sales credits for corporate bonds. Those

[48] Tr. 2860, 2899.

[49] Tr. 961-63.

[50] Tr. 2189, 2191.

[51] Tr. 2192, 2351-52.

[52] Tr. 2049.

[53] Tr. 2226.

factors include a bond's credit rating; maturity; supply; marketability; volatility; yield to maturity; and trading spread.

Once a broker-dealer determines the gross sales credit, the second step is to allocate the credit to various functional areas within the firm. One allocation is to compensate the registered representative for making the sale. Usually, a registered representative's payout is larger where there is a greater trading spread.[54] The size of sales credits are limited, however, by their impact on the bond's yield. If the credit is set too high, it can drag the bond's yield to a level below the prevailing yield for similar bonds.

MK testified that he set the sales credits on the Enron bonds based on their volatility and trading spreads, as he did with other corporate bonds.[55] Taking into account the greater-than-normal volatility and spreads caused by Enron's reported financial difficulties, MK at first set the gross sales credit at 1% ($10) and then soon raised the credit to 1.5% ($15).[56] Although above Respondent's written guidelines,[57] the gross sales credits on the Enron bonds were within the range of typical payouts for retail odd-lot bond trades for longer maturities, which were as high as 4%, depending on the bonds' characteristics.[58] The Enron gross sales credits also were in line with the credits MK previously set on other volatile bonds with large spreads. For example, MK testified that he had traded three or four different J.C. Penney bonds, which had spreads as great as five points, with gross sales credits ranging from one to three points ($10 to $30).[59]

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[54] Tr. 2517; RX-S, at 2-4.

[55] Tr. 2248-50.

[56] Tr. 2248, 6934.

[57] *See* CX03.005, at 23 (Fixed Income Department Policy and Procedures Manual). MK testified that he normally set credits of $3 to $8 on less volatile bonds with maturities similar to the Enron bonds. Tr. 2248.

[58] RX-S, at 4 (Respondent's Expert Rep't).

[59] Tr. 2307.

Respondent had similarly high gross sales credits on certain bonds issued by Lucent, Northern Telecom, Motorola, and IOS Capital.[60] In addition, evidence presented showed that other firms had set gross sales credits for the Enron bonds in the same general range as Respondent. Trade data collected by FINRA staff indicate that Wedbush Morgan Securities was paying $20 per bond on two of the Enron issues and that Southwest Securities was paying $30 per bond.[61] Enforcement presented no evidence to support its contention that MK set the gross sales credits at a higher level to motivate the sales force to concentrate its efforts on selling Enron bonds.

Despite the high gross sales credits on the Enron bonds, the registered representatives received small payouts because the volume of bonds they sold was quite low. The registered representatives sold a median number of ten bonds to each customer, which equated to a corresponding payout of about $52 per transaction.[62] Indeed, in many instances the registered representatives received less than $35 per transaction.[63] On average, the registered representatives received less than $100 per transaction.[64]

Overall, the Hearing Panel found no evidence that MK set higher sales credits to induce the Firm's registered representatives to sell Enron bonds. Nor did the Hearing Panel find evidence that any registered representative recommended Enron bonds because of the amount of the sales credits. To the contrary, all of the evidence pointed to the conclusion that the sales were driven by the anomalous yields then available on these investment-grade bonds. Further, there

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[60] Tr. 2307-08; RX-262.

[61] Tr. 2015; RX-F.

[62] RX-S, at 3. The Payout Guidelines Matrix in the Fixed Income Department Policy & Procedures Manual determined the registered representatives' compensation. In this case, their compensation averaged approximately 35% of the gross sales credit. *Id*.

[63] *See* RX-256b.

[64] *Id.* The total payout to the registered representatives for the transactions at issue equaled $10,139.54.

was no evidence that the size of the payouts caused the registered representatives to employ improper sales practices. In fact, Enforcement conceded that it could not demonstrate that the sales force engaged in any conduct typically associated with boiler-room operations or fraudulent sales schemes. As Enforcement stated, "None [of the registered representatives] worked off a script, bullet points, or a punch list when they recommended the bonds."[65]

B. Sale of Enron Bonds

1. Enron's Decline in Market Value in October and November 2001

Enforcement focused its case on the 17 trading days between October 29 and November 27, 2001. During this period, in an extraordinary sequence of events, Enron, the seventh-largest company on Fortune's list of the 500 largest U.S. companies,[66] experienced a precipitous decline in market value, ending with Enron and 14 of its affiliates filing voluntary petitions for Chapter 11 reorganization with the U.S. Bankruptcy Court for the Southern District of New York on December 2, 2001.[67]

Enron's market value was driven down by a stream of negative news Enron released to the public in October and November 2001. On October 16, Enron disclosed a non-recurring net loss of $618 million in the third quarter of 2001.[68] Enron incurred the loss after it wrote off $1.01 billion in failed investments, which included $35 million related to certain related-party entities run by Enron's Chief Financial Officer, Andrew S. Fastow ("Fastow").[69] On the same

[65] Enforcement's Post-Hearing Submission, at 35.

[66] RX-1.

[67] CX07.071.

[68] CX07.018, at 1.

[69] CX06.001, at 10; CX07.036, at 1, 4.

day, Enron also announced that it was posting a $1.2 billion reduction in shareholders' equity.[70] Although initially Enron did not provide a detailed explanation for the reduction, by early November 2001 it disclosed that the reduction was attributable to a restatement of certain financial transactions with "special purpose entities" or "SPEs" Fastow controlled.[71]

Enron had set up as many as 30 SPEs to access capital or hedge risk, while keeping the debts and liabilities of these entities off its books.[72] Enron's accounting practices regarding its use of SPEs had come under scrutiny by the SEC. On October 22, 2001, Enron publicly announced that the SEC had requested information about these related-party transactions.[73] Two days later, Enron announced that it had removed Fastow as Enron's CFO and put him on a leave of absence.[74]

On October 31, 2001, Enron announced that the SEC had opened a formal investigation into Enron's accounting procedures and disclosure policies relating to its use of the off-balance-sheet financing partnerships and that the company's Board of Directors had appointed a "Special Committee … to examine and take any appropriate actions with respect to transactions between Enron and entities connected to related parties."[75]

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[70] CX07.020, at 2.

[71] *See* CX06.001, at 9-10 (Enron Form 8-K dated November 8, 2001). An SPE is an "off-balance-sheet entity" used by firms to securitize, acquire, and lease assets. Typically, an SPE is a separate legal entity, such as a partnership or trust, set up for a limited purpose. SPEs can be employed to isolate financial risk and provide less-expensive financing than that which is available to their sponsors. Under applicable accounting rules in 2001, the sponsor of an SPE was not required to consolidate the assets and liabilities of an SPE on the sponsor's balance sheet as long as certain conditions were met. In Enron's case, it eventually became known that Fastow had created a complex web of SPEs in a fraudulent scheme to benefit himself and other senior Enron executives. However, the nature and extent of Fastow's illegal activities did not become public knowledge until after the period relevant to this proceeding.

[72] *See* CX07.036, at 5-6; CX07.048, at 3.

[73] CX06.002, at 15; CX14.001, at 1.

[74] CX05.056, at 173, 177; CX07.036, at 3; CX07.078, at 2.

[75] CX07.035, at 1.

On November 8, 2001, Enron filed a Form 8-K with the SEC in which Enron provided greater detail regarding the questioned related-party transactions.[76] In addition, Enron announced its intent to restate its financial statements for the years 1997 through 2000, and for the first two quarters of 2001.[77] The Form 8-K stated that, among other reasons, Enron was restating its financial statements to consolidate three limited partnerships, two of which were private-investment limited partnerships Fastow formed in 1999.[78] These entities, and their activities with Enron and other related parties, were the subjects of the investigations being conducted by the SEC and Enron's Special Committee. Enron estimated that its earnings for 1997 through 2000 would be reduced by $586 million and that its debt would be increased $2.58 billion.[79] In addition, Enron disclosed that it had fired its treasurer and another senior manager for making improper investments in one of its affiliates.[80]

Enron disclosed additional bad news in the second half of November. On November 19, Enron reported a quarterly net loss of $664 million and a further reduction of its reported third-quarter earnings.[81] Enron also disclosed that it might be required to make early payment of a $690 million note by the end of the month.[82] The following day, Enron announced that it could have to repay $9.15 billion in debt by 2003, which raised the possibility that it could run out of cash before it could complete a financial restructuring through a merger with Dynegy, Inc.[83]

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[76] CX06.001.

[77] *Id.* at 3.

[78] *Id.* at 4-5.

[79] *Id.* at 29-30.

[80] CX07.048, at 1.

[81] CX06.002, at 5, 12, 35-36, 69-70.

[82] CX07.060, at 1.

[83] CX07.062, at 1.

On November 9, 2001, Enron announced that it had entered into a merger agreement with Dynegy, which prospect caused the price of Enron bonds to rebound significantly.[84] However, Enron's worsening financial condition caused Dynegy to terminate the merger agreement on November 28, 2001.[85] Four days later, Enron filed a voluntary petition for Chapter 11 reorganization with the U.S. Bankruptcy Court for the Southern District of New York.[86]

2. Offering of Enron Bonds by the Fixed Income Department

In response to inquiries from the Firm's registered representatives, on October 29, 2001, MK added the three series of Enron bonds to Respondent's bond-offering screen. Respondent's senior management had no role in MK's decision.[87] The idea to offer Enron bonds came from the sales force, not the Firm. As Enforcement stated in its post-hearing brief, "What instantly attracted [the registered representatives] to the bonds were the positive aspects of the investments, such as their investment grade, high yield, and short-term maturity."[88]

MK received the initial request about the availability of Enron bonds from HS, an Respondent registered representative and District Manager.[89] HS testified that he started tracking Enron after reading a news story that there was some fluctuation in the prices of its bonds, which meant their yields might be attractive to some of his customers who were interested in investment-grade bonds with high yields.[90] He spoke to MK over several days to get his input on Enron.

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[84] CX06.002, at 13.

[85] CX07.069, at 1.

[86] CX07.071.

[87] Tr. 2224-25.

[88] Enforcement's Post-Hearing Submission, at 26.

[89] Tr. 2236, 2238, 2245; RX-208a, at 2.

[90] Tr. 3304-05.

At first, HS did not seek to buy Enron bonds because he considered the price too high.[91] Instead, he kept in touch with MK while waiting for the prices to fall. On October 29, 2001, MK advised HS that the quotes for Enron bonds had dropped significantly and that they were trading between 90 and 92 ($900 to $920 a bond).[92] With the drop in price, HS decided that the bonds would be a suitable investment for some of his customers. HS sent MK an e-mail asking when he could purchase some Enron bonds. MK wrote back and provided information about the outlook for the bonds. He advised HS that Moody's had just lowered its rating on Enron bonds from Baa1 to Baa2,[93] while Standard & Poor's had not changed its rating.[94] MK warned that the bonds could fall further if Enron had difficulty securing short-term financing. He also informed HS that the 9.875% June 2003 bonds were down seven points so far that day.[95] HS independently concluded that at least some of the bonds' volatility could be attributed to the market's tendency to overreact to breaking news in late 2001 following the attack on the World Trade Center on September 11.[96] Accordingly, HS did not consider the bonds too risky despite their drop in price and reduced rating.

After receiving MK's e-mail on October 29, 2001, HS placed an order for 25 Enron bonds.[97] MK filled HS's order by purchasing 250 of the 9.875% June 2003 Enron bonds.[98] MK

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[91] Tr. 3310.

[92] CX05.005; Tr. 2237, 3310-12.

[93] CX05.006. Moody's assigns a "Baa" rating to long-term obligations that are subject to moderate credit risk. "They are considered medium-grade and as such may possess certain speculative characteristics." CX07.001, at 12 (Moody's "Rating Symbols & Definitions" (Aug. 2004)).

[94] CX05.006.

[95] *Id.* at 1; *See* Tr. 2236-45.

[96] Tr. 3312-13.

[97] CX05.006, at 1; Tr. 3312-13.

[98] Tr. 2244-45.

testified that he had to purchase more than HS ordered to get the best price.[99] MK posted the balance on the bond-offering screen. MK testified that he was confident about moving the remaining bonds because he had received numerous calls about Enron bonds from other Respondent registered representatives, which led him to believe that there was a lot of demand for the bonds.[100]

Although it is not customary for investment-grade bonds to carry yields as high as bonds with a higher credit risk, MK had prior experience with similar situations.[101] Over the preceding year, MK had offered bonds issued by Nortel, Motorola, J.C. Penney, and Lucent, among others, which companies had experienced financial problems that caused the ratings and prices of their long-term bonds to fall and the yields to rise to higher-than-typical levels. In each case, the bonds were paid in full when they matured.[102] None of the companies defaulted despite the fact that most of the bonds' ratings had dropped below investment grade at times.[103]

3. Information About Enron Respondent Provided Its Sales Force

All of the foregoing negative developments regarding Enron were widely reported by both the financial news wires and the general media and were available to the sales force on the Firm's ILX system.[104] Nonetheless, once MK began offering Enron bonds, he supplemented the news feeds that were otherwise available to the Firm's registered representatives by posting

[99] Tr. 2244.

[100] Tr. 2322.

[101] Tr. 2302-04.

[102] Tr. 2303-04.

[103] Tr. 2304.

[104] Respondent's ILX system had two primary functions. First, it supplied real-time quotes on securities. Second, it supplied real-time news on securities and the markets. Tr. 2103-04. ILX also provided other functions, such as portfolio tracking and an options display screen.

selected news about Enron on StoryTeller. MK culled significant stories concerning Enron from various services, such as Bloomberg and Dow Jones, and copied them into StoryTeller.[105] In addition, MK posted ratings updates from Standard & Poor's and Moody's.[106] Thus, through the StoryTeller and ILX systems, as well as other news channels, the Firm's registered representatives had up-to-date, detailed information concerning developments at Enron, including the facts at the focus of Enforcement's case.[107] There was no allegation or evidence that MK (or anyone else at Respondent) withheld any publicly available material information about Enron from the Firm's sales force.

Not all the news on Enron was negative. There also were significant positive stories during this period that MK made available to the Firm's registered representatives. For instance, after Enron's debt rating was lowered, Standard & Poor's issued an opinion that the possibility of Enron losing its investment-grade rating was a "fairly remote possibility" and that Enron had "plenty of liquidity in the short-term that will get them through the current situation."[108] In addition, Credit Suisse First Boston Corporation, which provided stock research to Respondent, had maintained a "strong buy" recommendation on Enron stock until November 28, 2001, when Enron's long-term debt dropped below investment grade.[109] In addition, on November 1, 2001, Standard & Poor's reaffirmed its opinion that Enron's liquidity position was adequate.[110] Other positive developments in early November 2001 that were widely reported by the media were Enron's agreement to obtain a $1 billion loan from JP Morgan Chase and the merger agreement

[105] CX05.055; CX05.056.

[106] Tr. 1901-02.

[107] *See, e.g.*, Tr. 2046, 2103-04, 2337; CX05.055, at 37, 42, 53, 58, 68, 74.

[108] CX05.055, at 71.

[109] RX-22; RX-28 – RX-42.

[110] CX05.055, at 63.

with Dynegy.[111] Moreover, after Enron and Dynegy announced the merger, Dynegy issued assurances that the fundamentals of Enron's core business were sound.[112] Indeed, the news of the planned merger drove the price of the Enron bonds back up to 90 after many of Respondent's customers had bought the bonds for less.

As late as November 20, at the same time Enron's 10-Q reflected a going concern disclosure, Standard & Poor's announced that it expected Enron's credit situation to stabilize and Merrill Lynch announced that the news contained in Enron's 10-Q was not "likely to turn into a tornado, and are not deal-breakers in our opinion."[113] On November 20, Standard & Poor's and Fitch reaffirmed, and Moody's maintained, their investment-grade ratings on the Enron bonds.

JF monitored StoryTeller and occasionally would append notes to the stories MK posted.[114] JF used the StoryTeller system to alert the registered representatives to significant news and to provide cautionary notes regarding a bond's risk. One notable example was the cautionary note he added on November 8, 2001, which read: "These [Enron] bonds have become extremely volatile the last few weeks. 10 POINT moves in one day for 1-year paper have become common place with all the rumors running around. IT IS IMPORTANT THAT YOUR CLIENTS UNDERSTAND THIS!!!!!!!"[115]

JF stepped up his review of the Enron postings on StoryTeller when he noticed that there was an increase in the number of orders for Enron bonds from the sales force.[116] From his

[111] CX07.051, at 1.

[112] RX-43-0038, at 1-2.

[113] CX05.055, at 36, 37, 39.

[114] Tr. 1903-06.

[115] CX05.012, at 1; CX05.013, at 1.

[116] Tr. 1916.

review, JF knew that the news on Enron was mixed throughout November 2001 and that Moody's and Standard & Poor's repeatedly reaffirmed their investment-grade ratings for Enron's long-term debt.[117] JF also monitored the yields on the Enron bonds MK offered to the sales force. JF observed that the long-term bond yields were lower than the yields on the short-term bonds; he and MK considered this factor to signal investors' confidence in Enron's long-term bonds and in Enron's long-term viability.[118] MK and JF took these factors into consideration when they posted news and commentary for the registered representatives on StoryTeller.

4. No Evidence of Firm-Wide Omissions and Misrepresentations

Enforcement presented this case as one primarily involving material omissions by Respondent's registered representatives throughout the country.[119] At the hearing, Enforcement presented evidence regarding sales made by 54 [of the Firm's] registered representatives to more than 90 customers[120] between October 29 and November 27, 2001. In support of these specific allegations, Enforcement offered live testimony from 15 customers and one registered representative,[121] declarations from 75 customers who did not testify at the hearing,[122] and

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[117] Tr. 2055, 2057.

[118] Tr. 2011-12, 2343-44.

[119] Enforcement's Post-Hearing Submission, at 109. Enforcement also alleged that there were a few isolated instances where a few registered representatives misrepresented material facts in connection with their recommendations of Enron bonds.

[120] In some cases, the term "customer" refers to a joint account held by a husband and wife. Thus, Enforcement often referred to the number of affected customers as 134. *See* Enforcement's Post-Hearing Submission, at 39.

[121] One customer, JAB, testified by telephone on direct and then hung up before he could be cross-examined. When Enforcement could not reconnect the call, the Hearing Officer granted the Respondent's motion to strike his testimony. *See* Tr. 2618-19.

[122] CX08.

complaint letters and other related documentation from two other customers who did not testify.[123] In addition, Enforcement submitted Investment Questionnaires from 88 of the customers who either testified at the hearing or who submitted a declaration that was admitted into evidence.[124] Respondent countered Enforcement's evidence with live testimony from 34 registered representatives and declarations from 38 registered representatives, some of whom testified at the hearing.

Enforcement's central thesis was that the registered representatives, acting in concert, failed to apprise their customers of the negative publicly reported news regarding Enron, including the NRSROs' action to downgrade the credit rating on the Enron bonds and the SEC's decision to initiate an investigation into Enron's finances, and the non-public information that Respondent had removed Enron Capital Trust II preferred stock from its approved list because of concerns about Enron's debt rating and the SEC investigation. Enforcement argued that these facts, individually or collectively, were material because the registered representatives should have concluded from them that the NRSROs' credit ratings on the Enron bonds were erroneous and that the bonds were not investment grade despite their investment-grade ratings. The Hearing Panel disagreed.

The Hearing Panel found Enforcement's hypothesis that Respondent's registered representatives engaged in firm-wide fraudulent sales practices was inconsistent with the

[123] CX11.001; CX11.002.

[124] Enforcement originally submitted approximately 900 questionnaires with its proposed exhibits. However, the Hearing Officer who presided at the hearing admitted only those that related to those customers who testified at the hearing or whose declarations were admitted in evidence in order to have a complete record of those customers' prior statements. *See* Tr. 3046-53. Absent a witness's testimony or related declarations, the Hearing Officer determined that the Investor Questionnaires lacked reliability and probative value. In addition, the Hearing Officer determined that many of the questionnaires had been secured in a manner that raised serious fairness issues. *Id.* The Investor Questionnaires that are in evidence are identified by their respective exhibit numbers in the Amended Order Regarding Evidence Admitted at Hearing dated September 28, 2006.

evidence. The Hearing Panel found no evidence that Respondent's registered representatives intended to deceive, manipulate, or defraud their customers. To the contrary, the evidence clearly showed that the registered representatives sold the bonds in the regular course of business to customers for whom such investments were suitable.[125] Almost without exception, the registered representatives recommended small purchases, which cautious conduct was inconsistent with the fraud and overreaching Enforcement attributes to Respondent's sales force. Furthermore, the preponderance of the evidence showed that the registered representatives made reasonably balanced presentations to their customers when they recommended the Enron bonds, which included discussions of the publicly known reports about Enron's financial problems.

The registered representatives who testified at the hearing claimed that they properly explained the risks and rewards of investing in the Enron bonds. In substance, they said that they advised their customers that the Enron bonds presented a buying opportunity because their yields had been pushed to higher levels due to the widely disseminated negative media stories about Enron. They further testified that they informed their customers of the bonds' yields, maturities, coupon rates, ratings, and volatility. With regard to assessing the bonds' risk of default, the registered representatives consistently testified that they relied on the ratings supplied by Moody's and Standard & Poor's.

The Hearing Panel found the registered representatives' testimony to be truthful and credible. The registered representatives would not have been able to explain the unusually high yields without referring to the negative media reports about Enron. Some customers recounted

[125] Enforcement conceded that all of the recommendations were suitable and that there was nothing inherently improper in offering the Enron bonds to customers despite the bonds' volatility. As counsel for Enforcement stated at the close of the hearing, "[The high yields on Enron bonds] presented an unusual investment opportunity, one that broker-dealers should look for. We have no problem with that. It's also one that the Department does not fault [Respondent] for presenting to its customers. We don't have a problem with that either." Tr. 7217.

posing questions and discussing why the yields on the Enron bonds were so high. In contrast, the Hearing Panel found the customers' testimony to be less reliable. On pivotal issues, the customers' testimony was inconsistent and contradictory. For example, although Enforcement claimed that the customers had not discussed the specific risks associated with the Enron bonds with their registered representatives, a number admitted otherwise. One such customer was JW, who purchased 10 bonds on November 7, 2001, after he called his broker and asked for a recommendation of a high-yield investment. Contrary to Enforcement's contention, JW admitted that he specifically discussed with his registered representative the possibility that Enron might fail.[126] JW concluded that such an event was unlikely, so he proceeded with the purchase. JW stated that he independently evaluated the situation and concluded that the market had overreacted to the news about Enron and had misevaluated the risks at Enron.[127] JW considered his risk evaluation a prudent business decision given the potential rate of return.[128] JW believed that the worst-case scenario was that Enron would merge with another company, and he was encouraged when he learned that the potential of the Dynegy merger had caused the price of the bond he purchased to climb from his purchase price of $74 to $90.[129]

Another customer, AKW, admitted that he specifically discussed the fact that Enron's credit rating had been reduced and that he knew this meant that Enron was in financial difficulty.[130] AKW concluded that the high return was worth the risk, and he purchased seven

[126] Tr. 470-72.

[127] *See* Tr. 460, 470-72.

[128] Tr. 470-72.

[129] *See* Tr. 412, 414, 425-26.

[130] *See* Tr. 1643-44, 1672, 1683.

bonds on November 1, 2001. AKW further testified that he was not overly concerned about the possibility that he might lose "$7,000 out of $150,000 in the account."[131]

In addition, AKW admitted that his registered representative called him after he purchased the Enron bonds to update him about additional negative news.[132] Other customers reported receiving similar follow-up calls. Customer CHC, for example, testified that his registered representative called him shortly after he purchased five bonds on October 30, 2001, to alert him to reports in the media about Enron's developing problems.[133] CHC had purchased the bonds before the SEC announced on October 31 that it was elevating the status of its inquiry into Enron's finances to a formal investigation and before the rating downgrade was announced at the close of business on November 1.

Customer RAC also admitted that he knew a lot about Enron and had discussed specific risk factors with his registered representative. RAC, an accountant by profession and an experienced bond investor, testified that he was "generally familiar with" and "knew quite a bit" about Enron, and "was aware there was a third-quarter loss for 2001" and that Enron was having some accounting issues.[134] Further, RAC testified that he was sure that he discussed the third-quarter loss with his registered representative.[135]

Another key area where the Hearing Panel found the customers' testimony as a whole to be unreliable related to their claims that they were risk-averse investors. In many cases, the customers' testimony on cross-examination, or other evidence such as their account

[131] Tr. 1646. AKW had a total net worth of approximately $1.5 million. Tr. 1665.

[132] Tr. 1651-53.

[133] Tr. 154.

[134] Tr. 2637-38, 2706.

[135] Tr. 2639.

documentation, showed otherwise. For example, Enforcement's first witness, AS, testified that he was a conservative investor, looking for income with limited risk.[136] However, AS's purchase of 20 Enron bonds on November 1, 2001, actually was consistent with his prior purchases of high-yielding bonds. For example, AS had previously bought 35 AT&T Canada bonds at deep discounts when he knew the company was having problems.[137] AS, himself a registered representative with more than 40 years experience with the bond market, explained his AT&T investment as follows: "I knew that AT&T Canada had some problems there but I bought the AT&T and I said in the end it's going to come out all right and it did come out all right."[138] AS also had purchased high-yield bond funds.[139] In addition, he continued to make high-risk investments after the Enron bonds declined in value.[140] AS admitted taking risks on these higher-risk securities was consistent with his investment philosophy. He referred to these higher risk investments as "play money."[141] Moreover, when he read adverse news regarding Enron after his purchase, he did not complain or consider selling the bonds and continued with his broker thereafter.[142]

CHC also had a more aggressive investment record than he claimed, and he generally made his own investment decisions.[143] Except for a single real estate transaction, CHC never

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[136] Tr. 70.

[137] Tr. 103-05.

[138] Tr. 63, 104.

[139] Tr. 98-99.

[140] Tr. 106-11.

[141] Tr. 111. For example, he purchased Biolace Technology at $2.00 per share on the advice he received from a friend at a cocktail party. Tr. 110.

[142] Tr. 116-19, 6246. Other customers likewise stayed with the same registered representative long after Enron's collapse.

[143] *See* 171.

followed any of the advice or recommendations that his registered representative made.[144] In the fall of 2001, CHC had cash in his account that he wanted to invest, and he asked his registered representative to buy Ford stock in his account although he knew that Ford was having various problems and the price of its stock had fallen.[145] CHC testified the lower price provided him with a buying opportunity and he expected the Ford stock would then go back up.[146] After buying the Ford stock, CHC decided to invest the balance he had on hand in Enron bonds although he was "skeptical" about the bonds because of their high yield.[147] In addition, CHC had purchased a penny stock a year earlier after reading a newspaper article about the company.[148] Contrary to his claim, CHC's customer profile showed that he had not instructed his registered representative to limit his account to low-risk investments.[149]

WMS, who bought five Enron bonds on November 1, 2001, also testified that he was a conservative investor, but his account record showed that he had classified himself as a "moderate" investor.[150] His higher-than-admitted risk tolerance was borne out by his investment history. Smith had purchased corporate bonds, and a wide variety of stocks, including penny stocks, before he bought the Enron bonds. WMS testified his purchases of Ford, GM and Georgia Pacific corporate bonds were the type of investments that he wanted, even after he had watched the prices of some of the bonds drop.[151] He also testified Georgia Pacific was "kind of a

[144] Tr. 136.

[145] Tr. 138-39.

[146] Tr. 139.

[147] Tr. 165.

[148] Tr. 171, 184.

[149] RX-1140.

[150] RX-1875.

[151] Tr. 328-31, 364-65.

flyer" that he bought after talking to his brother, who also purchased the bond.[152] Moreover, WMS purchased penny stocks that he had personally found—forestindustry.com and iJoin Systems—against the advice of his registered representative.[153] WMS also had made his own decision to purchase such other stocks, as Quadracomm (at three cents a share) and Emulex, a tech company.[154]

Another notable example was RJT, who had been a customer of the same registered representative at Respondent for approximately 10 years. RJT claimed that he told his registered representative that he wanted low-risk investments,[155] but his testimony and trading records indicate that since 1994 he had been an extremely active trader in common stocks with a moderate risk tolerance, who was buying and selling $30,000 to $80,000 positions (in an account that generally had assets around $120,000) within a week to a month (sometimes doing roundtrips in one day) in a number of companies including Boeing, Philip Morris, and Motorola.[156] RJT also claimed that he did not have "a whole lot" of investment experience, but his testimony and account documents indicate that he "had quite a bit of buying and selling" experience (20 years) and did "quite a few trades" in Ford bonds between 1995 and 1999.[157] Finally, RJT claimed that he became more cautious due to his bad experience with the Enron bonds, but his own testimony details that he remained an extremely active investor.[158]

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[152] Tr. 363-65.

[153] Tr. 333-34.

[154] Tr. 367-71.

[155] Tr. 2734.

[156] Tr. 2765-66; RX-1937. *See generally* RX-1936.

[157] Tr. 2735-36; RX-1937.

[158] Tr. 2754, 2778-79.

Despite the foregoing inconsistent evidence contradicting the central theory of Enforcement's case against Respondent, Enforcement nonetheless argued that the Hearing Panel should give greater weight to the customers' testimony alleging that they had been defrauded than to that of the registered representatives denying any wrongdoing. Enforcement pointed to the similarities in some of the customers' declarations as evidence of the customers' credibility.[159] However, the Hearing Panel did not find the apparent consistency compelling. Rather, the Hearing Panel concluded that the superficial consistency among some of the customers' declarations resulted from the manner in which Enforcement investigated this case and the fact that Enforcement drafted the declarations.[160] It is evident that many of the words in the declarations were chosen by Enforcement, not the customers, thereby creating an artificial appearance of consistency. Under these circumstances, the Hearing Panel rejected Enforcement's contention that the apparent consistency in the wording of the declarations was an indicator of their reliability.

In addition, the Hearing Panel declined to give greater weight to the customers' declarations than to the registered representatives' testimony, which the Hearing Panel found credible. Hearsay evidence such as the declarations submitted in this case is generally admissible in FINRA disciplinary proceedings, "and, in the appropriate case, even may afford the sole basis for findings of fact."[161] However, the extent to which a panel can rely upon hearsay evidence depends upon its "probative value, reliability, and the fairness of its use."[162] "Among the factors

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[159] *See* Enforcement's Post-Hearing Submission, at 38.

[160] Tr. 787-88, 1312-13. The declarations were prepared from completed questionnaires, which Enforcement also drafted. Tr. 1046-47.

[161] *See, e.g., Charles E. French*, Exchange Act Release No. 37409, 52 S.E.C. 858, 862, 1996 SEC LEXIS 1802, at *11 n.17 (July 8, 1996).

[162] *Mark James Hankoff*, Exchange Act Release No. 30778, 50 S.E.C. 1009, 1012, 1992 SEC LEXIS 1319, at *7 (June 4, 1992). *See, e.g.*, *Gary L. Greenberg*, Exchange Act Release No. 28076, 50 S.E.C. 242, 245, 1990 SEC LEXIS 1141, at *7-8 (June 1, 1990) (citing *Richardson v. Perales*, 402 U.S. 389,

to be considered in determining whether to credit hearsay are the possible bias of the declarant; whether or not the statements are contradicted by direct testimony; the type of hearsay at issue; whether the missing key witness was available to testify; and whether or not the hearsay is corroborated."[163] "[M]ere hearsay lacking sufficient assurance of its truthfulness is not substantial evidence to overcome … sworn testimony."[164]

The Hearing Panel concluded that the record did not provide sufficient assurance of the reliability of the customers' declarations to credit them over the registered representatives' testimony. As discussed above, the declarations were conclusory and contained language supplied by Enforcement rather than the customers' actual recollection of the statements and omissions attributed to the Respondent registered representatives. This factor is particularly significant in this case because the customers were asked to supply information about brief conversations that had occurred years earlier. Further, some of the customers testified contrary to statements in their declarations on pertinent issues, raising serious issues about the reliability of the declarations in general. These factors significantly undercut the reliability of the declarations. Accordingly, the Hearing Panel credited the registered representatives' testimony over the customers' declarations.

In conclusion, the Hearing Panel determined that Enforcement failed to show by a preponderance of the evidence that the Respondent registered representatives acted in a concerted manner to mislead customers through omissions and misrepresentations of material facts.

407-08 (1971)). *See also Kevin Lee Otto*, Exchange Act Release No. 43296, 54 S.E.C. 847, 854, 2000 SEC LEXIS 1932, at *14 (Sept. 15, 2000), *aff'd sub nom. Otto v. SEC*, 253 F.3d 960, 966 (7th Cir. 2001).

[163] *Greenberg*, 50 S.E.C. at 245.

[164] *Hoska v. United States Dep't of the Army*, 677 F.2d 131, 139 (D.C. Cir. 1982).

5. No Evidence of Nationwide Campaign by Fixed Income Department to Sell Enron Bonds

The Hearing Panel found no evidence to support Enforcement's characterization that the Fixed Income Department engaged in a "nationwide campaign" to sell Enron bonds to the Respondent's customers.[165] Enforcement based this allegation on the fact that once the Fixed Income Department began offering Enron bonds "Respondent's sales force sold little else when it came to corporate bonds with similar maturities."[166] But this pattern was neither extraordinary nor unexpected under the circumstances. As Enforcement pointed out, throughout 2001, there were several instances where Respondent's sales force sold high concentrations of short-term corporate bonds with high yields due to the issuers' financial problems. For example, in the first three months of 2001, Respondent sold short-term J.C. Penney bonds almost exclusively.[167] During those months, sales of short-term J.C. Penney bonds amounted to more than 94% of all the short-term bonds sold by Respondent.[168] The same pattern was repeated in April and May 2001 with the sales of Lucent short-term bonds, and again in July through August 2001 with the sales of Nortel short-term bonds.[169] In each of these situations, the prime motivating factor behind the sales was the exceptionally high yields available on these bonds because their prices had been driven down by bad financial news about the companies. Many of Respondent's registered representatives and customers saw these as buying opportunities, where they could get exceptionally high yields on short-term investment-grade bonds. Moreover, these recurrent sales patterns in 2001 developed even though the Fixed Income Department had not set sales credits

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[165] *See* Enforcement's Post-Hearing Submission, at 13-26.

[166] *Id.* at 21.

[167] *See* Enforcement's Post-Hearing Submission, at 21 n.28.

[168] *See generally* Tr. 1132-34.

[169] *See* Enforcement's Post-Hearing Submission, at 21 nn.29-30.

as high on the J.C. Penney, Lucent, and Nortel bonds as those on the Enron bonds, a fact which undermines Enforcement's theory that the sales of Enron bonds were spurred by the high sales credit.[170]

C. Supervision

1. Respondent's Overall Supervisory Structure

During the relevant period, Respondent had a multi-tiered supervisory structure for the sales force. The first-tier supervisors were the Firm's Branch Office Managers.[171] The Branch Office Managers were assigned responsibility for monitoring the activities of the registered representatives, sales assistants, and other employees in the branch for compliance with applicable laws, rules, regulations, and Respondent's policies and procedures.[172] They had primary responsibility for reviewing incoming and outgoing correspondence, new account applications, and sales activities.[173] The Branch Office Managers also were responsible for monitoring customer accounts for signs of irregular, inappropriate, or unsuitable trading.[174] Under the Firm's written procedures, the Branch Office Managers were required to review the trades of every registered representative assigned to his or her branch office on a daily basis using a printout of detailed information about each customer's risk profile, investment objective, net worth, and investment experience as reported by the customer in his or her most recent "Customer Preference Profile."[175]

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[170] *See* CX-15, at 12 n.17.

[171] Most of Respondent's offices were relatively small. Typically, each branch office manager supervised five or six registered representatives.

[172] Tr. 2913-14; CX03.002, at 4.

[173] CX03.002, at 4.

[174] *Id.*

[175] *Id.* at 13; Tr. 2913-17.

The second-tier supervisors were the Firm's District Managers, who reported to Regional Managers. District Managers were responsible for reviewing any reported exceptions related to sales and trade reporting.[176]

Respondent also had Regional Sales Supervisors who were responsible for reviewing customer sales activity of the registered representatives within their assigned regions to ensure that such sales were suitable and consistent with applicable laws and regulations and Firm policy.[177] The Regional Sales Supervisors reported to Regional Managers.[178]

In addition, Respondent had Regional Compliance Managers in the sales practice unit of the Compliance Department. Their designated function was to assist with the education of the Branch Office Managers and registered representatives on compliance issues.[179]

Respondent had a number of manuals that governed its operations, including its compliance and supervisory systems. The Firm had a Compliance Manual,[180] a Regional Compliance Manager Manual,[181] a Regional Sales Supervisor Manual,[182] a Branch Office Manager Manual,[183] a Fixed Income Department Policy and Procedures Manual,[184] a Fixed

[176] Tr. 2916-17.

[177] CX03.004 at 3; Tr. 2917-18.

[178] Tr. 2917-18.

[179] Tr. 2864, 2867.

[180] CX03.001 (Respondent Financial Advisors Compliance Manual). The Compliance Manual addressed the risks associated with bond investments. *Id.* at 113-14, 116-17 (interest rate risk, reinvestment risk, default risk, call risk, inflation risk, liquidity risk, and exchange rate risk, and appropriate risk disclosures). *Id.* at 113-14.

[181] CX03.003.

[182] CX03.004.

[183] CX03.002.

[184] CX03.005 ("[PF] Fixed Income Policy & Procedures Manual").

Income Trading Department Policies and Procedures Manual,[185] and a Fixed Income Training Manual.[186] In addition, with respect to the Fixed Income Department, Respondent had a Fixed Income Supervisory Manual that was originally developed by PF.[187] Under the Firm's written procedures, JF was obligated to review order tickets, bond prices charged to customers, daily position reports, training materials, and sales credits.[188] JF also was required to review daily transaction reports for prices, yields, and maturity dates.[189]

Respondent's written procedures were largely the product of revisions made following the settlement of PF's sales practice violations that occurred in the early to mid-1990's.[190] Pursuant to a 1998 settlement with the SEC, PF was obligated to retain an independent consultant to conduct a firm-wide review of its sales practices and supervision.[191] Respondent's Fixed Income Department was not involved. The independent consultant Respondent retained conducted several reviews between 2000 and 2005, and reports of his findings and recommendations were filed with the SEC.[192] In addition, Respondent retained outside attorneys to monitor for compliance with the consultant's recommendations. Their reports in 2002 and 2005 covered the Firm's sales practices for fixed income products as well as equities.[193]

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[185] CX03.006.

[186] CX03.007. *See generally* Tr. 2478-79.

[187] CX03.008; Tr. 1970-72, 2882-84. Respondent was in the process of updating the PF Fixed Income Supervisory Manual during the period in question. In November 2001, Respondent's Compliance Department had put together a proposed revision, and JF testified that he was in the process of providing further revisions.

[188] Tr. 1850-55.

[189] Tr. 1851.

[190] Tr. 2927.

[191] CX01, at 77-78; Tr. 2937.

[192] Tr. 2928-29, 2937-41.

[193] Tr. 2939-41, 2946-48, 2950-51.

Enforcement took issue with the adequacy of two aspects of the Firm's supervisory system and procedures. Enforcement argued that the Firm's supervisory system was inadequate because it did not require "enhanced" supervision of the sales of bonds with inflated gross sales credits and that the Firm's written supervisory procedures were inadequate because they did not specifically address the process by which the Fixed Income Department acquired and made corporate bonds available to the sales force. For the reasons discussed below,[194] the Hearing Panel rejected Enforcement's arguments.

IV. CONCLUSIONS OF LAW

A. Fraudulent Omissions and Misrepresentations

1. Legal Standard

Section 10(b) of the Exchange Act makes it "unlawful for any person … [t]o use or employ, in connection with the purchase or sale of any security …, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe …."[195] SEC Rule 10b-5 makes it unlawful

> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To … omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
>
> (3) To engage in 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.[196]

[194] *See* Sections IV(C)(2) and IV(C)(3).

[195] 15 U.S.C. § 78j(b).

[196] 17 C.F.R. § 240.10b-5.

Liability for failing to disclose material information is "premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[197] A registered representative owes such a duty to his customers to disclose material information fully and completely when recommending a transaction.[198]

To establish a violation of the antifraud provisions of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Conduct Rule 2120,[199] Enforcement must prove by a preponderance of the evidence that: (1) the registered representatives made omissions or misrepresentations in connection with the purchase or sale of a security; (2) the omissions or misrepresentations involved material information; and (3) the omissions or misrepresentations were made with scienter.[200] A failure to prove any of the elements requires dismissal of the fraud charges.

2. Registered Representatives Did Not Act Recklessly in Relying on the Bonds' Investment-Grade Ratings

Enforcement contended that Respondent's registered representatives misrepresented the default risk associated with the Enron bonds by telling their customers that the bonds were investment grade. Enforcement argued that the registered representatives should have told their customers that they were actually junk bonds and therefore had a corresponding higher risk of

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[197] *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

[198] *See De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002) ("[T]he broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale."); *Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc.*, 794 F.2d 198, 200 (5th Cir. 1986) ("The law imposes upon the broker the duty to disclose to the customer information that is material and relevant to the order."); *Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969); *SEC v. Hasho*, 784 F. Supp. 1059, 1106-07 (S.D.N.Y. 1992).

[199] NASD Conduct Rule 2120 is FINRA's antifraud rule and is similar to Section 10(b) and Rule 10b-5. *Market Regulation Comm. v. Shaughnessy*, No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (N.B.C.C. June 5, 1997), *aff'd*, 53 S.E.C. 692 (1998).

[200] *See, e.g., Anthony Cipriano*, No. C07050029, 2007 NASD Discip. LEXIS 23, at *21 (N.A.C. July 26, 2007).

default notwithstanding the contrary opinion of the NRSROs. Enforcement argued that the registered representatives should have considered them to be junk bonds because the size of the yields and the degree of volatility were commonly associated with junk bonds, not investment-grade securities. Thus, Enforcement contended that the registered representatives should have advised their customers that the bonds' default risk was higher than the NRSROs' ratings indicated. The Hearing Panel rejected Enforcement's argument.

The NRSROs' ratings incorporated the known public facts that Enforcement highlighted to show that Respondent's registered representatives misrepresented the bonds' default risk—losses, earnings and equity restatements, rating downgrades, and the SEC investigation. Consequently, the NRSROs' ratings represented their expert opinions of the bonds' default risk based on all of the publicly available information concerning Enron, as well as private information supplied by Enron under the terms of its contracts with the NRSROs.[201] Under the circumstances, the registered representatives lacked a reliable basis to conclude that all of the NRSROs had misevaluated Enron's default risk. Moreover, the registered representatives' reliance on the NRSROs' ratings was consistent with the special treatment accorded to investment-grade ratings under numerous state and federal statutes and regulations.[202] The

[201] In addition, all of these facts were reported prominently in the national news media, and, therefore, were incorporated into the total mix of information reasonably available to the customers. *See Starr v. Georgeson S'holder Inc.*, 412 F.3d 103, 110 (2d Cir. 2005). *See also* RX-84 – RX-95 (copies of news articles). Neither the NRSROs nor the registered representatives knew that Enron, through Fastow, had intentionally released fraudulent financial information to mislead the NRSROs, investment analysts, and investors.

[202] *See, e.g.*, Exchange Act Rule 15c3-1(2)(vi)(E), 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E); Exchange Act Rule 15c3-1(c)(2)(vi)(F), 17 C.F.R. § 240.15c3-1(c)(2)(vi)(F); Federal Deposit Insurance Act, 12 U.S.C. § 1831e(d)(4)(A); Investment Company Act Rule 2a-7, 17 C.F.R. § 270.2a-7; Exchange Act § 3(a)(41), 15 U.S.C. § 78c(a)(41); Cal. Ins. Code § 1192.10; Tex. Ins. Code art. 2.10-4; N.J. Stat. § 17:24-29.

Hearing Panel found that the registered representatives acted reasonably in relying on the bonds' ratings.[203]

Furthermore, the Hearing Panel did not find the directional information material in light of all of the other information given to and known by the customers. When a registered representative recommends a security to a customer, he must disclose "material adverse facts."[204] Whether information is material "depends on the significance the reasonable investor would place on the ... information."[205] Information is material "if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest] ... and the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[206] Courts have held that "[t]he 'total mix' of information includes all information 'reasonably available to the shareholders.'"[207] In other words, the omitted information must reflect facts that differ in a material way from the facts that actually existed at the time of the alleged omission or misrepresentation. Materiality is not determined retrospectively based on how events unfolded.[208]

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[203] Enforcement cited no rule or regulation that required disclosure of previous downgrades or supplemental directional information, such as CreditWatch.

[204] *Richard H. Morrow*, Exchange Act Release No. 40392, 1998 SEC LEXIS 1863, at *19 (Sept. 2, 1998) (citation omitted).

[205] *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988); *Martin R. Kaiden*, Exchange Act Release No. 41629, 1999 SEC LEXIS 1396, at *18 n.25 (July 20, 1999). *See also TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (rejecting as a standard what a reasonable investor "might" consider important).

[206] *Basic v. Levinson*, 485 U.S. at 231-32 (quoting *TSC Indus. v. Northway*, 426 U.S. 438, 449).

[207] *Starr v. Georgeson S'holder, Inc.*, 412 F.3d 103, 110 (2d Cir. 2005) (quoting *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 130 (2d Cir. 2000).

[208] *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

Here, the overwhelming weight of the evidence demonstrated that the alleged specific shortcomings in the disclosures made by some of the registered representatives[209] were immaterial when judged by the foregoing standard. Unlike the usual case involving material omissions in connection with the sale of securities, here the national news media were awash with negative stories about Enron that disclosed the very facts Enforcement claimed Respondent's registered representatives omitted when they recommended Enron bonds to their customers. The national and local news media ran hundreds of pages of news stories about Enron during the relevant period.[210] Furthermore, the evidence shows, for the most part, that the customers who purchased Enron bonds did so because the bonds' price had been beaten down, thereby raising their yield-to-maturity above what was typical for investment-grade bonds. Under these circumstances, and viewing each alleged omission in context, the Hearing Panel concluded that the Respondent registered representatives did not recklessly disregard their duty to disclose material adverse facts bearing on the risk that Enron would default on its obligation to pay the bonds when they fell due.

3. Respondent's Decision to Drop Enron Preferred Stock from List of Approved Securities Not Material to Bond Investors

Respondent's Equity Research Department maintained a list of equity securities that the Respondent registered representatives could recommend to their clients.[211] Securities were regularly added to and removed from the list.[212] The list included preferred stocks that registered representatives could offer to customers.[213] In order for a preferred stock to be included on the

[209] The evidence showed that many registered representatives did inform their customers about the downgrades. *See, e.g.*, Tr. 3368, 5427, 5618; CX08.064.

[210] *See* RX-84 – RX-95.

[211] Tr. 2095.

[212] RX-80.

[213] Tr. 2094-95.

approved list, the preferred stock had to be an issue for which Respondent or PF was part of the selling group.[214] However, even if the stock met that criterion, it would not be included on the approved list unless its liquidity, credit rating, and yield were adequate, and the security attracted client interest.[215] In the fourth quarter of 2001, Respondent had about 100 preferred securities on its approved list.[216] LS, the head of the Equity Research Department, was solely responsible for deciding which securities were added to and deleted from the approved list.[217] LS had discretion to remove securities from the approved list; he did not need to base his decision to remove a security on verified independent research.

On or about October 23, 2001, almost a week before the corporate bond desk began offering Enron bonds, LS removed the Enron Capital Trust II preferred stock from the Firm's list of approved securities because of his concerns over its credit quality based on publicity concerning the SEC's investigation into certain transactions between Enron and related limited partnerships—the same public information known to the NRSROs and the Firm's registered representatives.[218] LS did not base his decision on other facts, fundamental analysis, or research.[219] This action was communicated to the sales force through the ILX System so they would know that they could no longer recommend the stock.[220]

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[214] Tr. 2095.

[215] Tr. 2095-96, 2107-08.

[216] Tr. 2154.

[217] Tr. 2106-07.

[218] CX05.003; Tr. 2230.

[219] Tr. 2115-20, 2122. In addition, LS testified that he did not base his decision to remove Enron Capital Trust II preferred stock on any concern about Enron's liquidity. Tr. 2122.

[220] Tr. 2117. Respondent's registered representatives were not required to recommend that customers sell any securities removed from the Firm's approved list, however. Tr. 2137.

Enforcement based a substantial portion of its case against Respondent on the fact that it did not as a matter of policy require LS to advise the Fixed Income Department when he removed an equity security from the Firm's approved list of securities, and on the allegation that many of the registered representatives did not tell their customers that Respondent had dropped the Enron Capital Trust II preferred stock from the Firm's approved list of securities. Enforcement argued that Respondent's procedures were inadequate because they did not require LS to share this type of information with the Fixed Income Department. In addition, Enforcement contended that LS's action was a material fact that had to be disclosed to customers who later purchased Enron bonds. The Hearing Panel disagreed.

The decision to remove Enron Capital Trust II preferred stock from the Firm's approved list of securities was irrelevant to the credit quality (default risk) of the Enron bonds and not meaningful to either MK or a reasonable investor. The Enron Capital Trust II preferred stock was completely different from the Enron bonds. Among other things, the preferred stock had different trading characteristics and exposure to market trends, and lacked a maturity date. In addition, Enron did not issue these securities. Enron Capital Trust II, one of Enron's special purpose financing entities, issued these securities.[221] Accordingly, the risks associated with the Enron Capital Trust II preferred securities, which were part of the off-balance-sheet financing under investigation by the SEC, were quite distinct from the default risk of the Enron bonds. Indeed, far more relevant to the bonds' default risk was the fact that throughout most of the period in question the research reports on Enron's common stock remained positive. Moreover, as MK testified, LS's decision to remove the preferred stock was based on "public information"

[221] The Hearing Panel concluded that these preferred securities were of the class known as Monthly Income Preferred Securities or "$25 preferred securities" because they typically have a $25 par value. Monthly Income Preferred Securities usually represent a limited partnership interest in a company that exists solely for the purpose of issuing preferred securities and lending the proceeds of the sales to its parent company.

that was duplicative of what MK "would have already seen."[222] As such, MK testified that he would not have acted differently if he had known that LS had dropped the Enron Capital Trust II preferred stock from the Firm's approved list of securities.[223]

In short, Enforcement failed to prove widespread, systematic, or firm-encouraged misrepresentations or omissions, and, to the extent that Enforcement showed any negligent omissions, the omitted facts were not material. Accordingly, the Hearing Panel concluded that the evidence did not support the charges in the first two causes of the Complaint. Moreover, even if the Hearing Panel were to conclude that some omissions were material, the fraud charges nevertheless must be dismissed because Enforcement failed to establish scienter, an essential element of securities fraud under Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Conduct Rule 2120.

4. Scienter Unproven

For purposes of securities fraud cases, scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud."[224] Scienter may be established by proof of conscious behavior or recklessness on the part of the respondent.[225] Reckless conduct includes "a highly

[222] Tr. 2230-31. Similarly, JF testified that he would not have altered his evaluation of the creditworthiness of the Enron bonds if he had known of LS's decision. JF pointed to the different nature of preferred securities, the more focused purpose of the preferred securities list, and the fact that LS routinely added and deleted preferred securities. Tr. 1957-58, 1960-61.

[223] Tr. 1960-61.

[224] *Tellabs, Inc. v. Makor Issues & Rights, LTD*, 127 S.Ct. 2499, 2507 (2007) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 and n.12 (1976)).

[225] *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990) (en banc). Although the Supreme Court has not addressed the question of whether reckless conduct may meet the scienter requirement, every Court of Appeals that has considered the issue has held that it does. *See Tellabs v. Makor*, 127 S.Ct. at 2507 n.3 (citing *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338 (4th Cir. 2003) (collecting cases)). The SEC also has applied recklessness as a standard to establish scienter. *See, e.g., Irfan Mohammed Amanat*, Exchange Act Release No. 54708, 2006 SEC LEXIS 2545, at *34 (Nov. 3, 2006).

unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which 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."[226] No degree of negligence is enough to satisfy the scienter requirement because "recklessness is a form of intent rather than a greater degree of negligence."[227]

There is both an objective and subjective component to scienter in securities fraud cases. "The objective component of scienter asks what a reasonably prudent securities professional under the circumstances would have done. … The subjective component looks at an actor's actual state of mind at the time of the relevant conduct."[228]

The Hearing Panel finds that Enforcement failed to show by a preponderance of the evidence that any Respondent registered representative acted with scienter. Enforcement premised its fraud case against Respondent on the argument that the level of sales credits MK placed on the Enron bonds satisfied the scienter requirement. Under Enforcement's theory of the case, the high sales credits induced the Firm's registered representatives to mount an untruthful or reckless campaign to sell Enron bonds rather than other lower-yielding and less-risky bonds.[229] Enforcement further argued that the Hearing Panel could infer that Respondent acted with scienter from the fact that "[Respondent] knew that its failure to disclose *obvious information* concerning the risks of investing in Enron presented a danger of misleading

[226] *Gebhart v. SEC*, 2007 U.S. App. LEXIS 27183, at *2 (9th Cir. 2007) (quoting *Hollinger v. Titan*, 914 F.2d at 1569) (quoting *Sundstrand Corp. v. Sun Chem. Corp*., 553 F.2d 1033, 1045 (7th Cir. 1977)).

[227] *In re Silicon Graphics*, 183 F.3d 970, 977 (internal quotation marks and citation omitted).

[228] *Gebhart v. SEC*, 2007 U.S. App. LEXIS 27183, at *3 (citations omitted).

[229] Tr. 3075-76.

customers."[230] However, Enforcement's hypothesis is inconsistent with the evidence and the reasonable inferences that can be drawn from the evidence.

All of the credible and reliable evidence shows that the Firm's registered representatives recommended Enron bonds to their customers because they believed the bonds were a good investment for customers seeking a high, short-term yield. Contrary to Enforcement's argument that the registered representatives possessed "information and analysis of Enron's condition that painted a more dire picture than available in various news articles,"[231] the evidence shows that they relied on the public information and the bonds' credit ratings when forming their recommendations. The Firm's registered representatives had no reliable information indicating that the bonds' risk of default was higher than that incorporated into the ratings assigned by Moody's and Standard & Poor's. No one at the time knew the full extent of the problems at Enron. The nature and extent of Fastow's fraudulent conduct did not become known for many months after the relevant period. Thus, the Firm's registered representatives could not have foreseen the ultimate significance of some of the information available in October and November 2001, such as the SEC's investigation of the Fastow partnerships, in order to second-guess the bonds' ratings. In addition, throughout the period in question, there was an active market in Enron bonds, which signaled broad-based belief that Enron's problems were temporary, albeit serious, in the short run.

Without the benefit of hindsight, the various news stories in October and November 2001 would not have alerted a reasonably prudent securities professional to conclude that Enron, the seventh-largest company in the United States, was about to collapse. The losses and adjustments to the balance sheet that Enron announced in the third quarter of 2001 were reported as one-time

[230] Enforcement's Post-Hearing Submission, at 114 (emphasis added).

[231] Enforcement's Post-Hearing Submission, at 113.

events to correct accounting errors. There were no reported facts indicating that these adjustments were the result of massive criminal fraud with the potential for destroying the company. The press release announcing that the SEC had initiated a formal investigation stated that the SEC "[is] investigating partnerships run by former CFO Andrew Fastow that bought and sold Enron shares and assets."[232] While Enron and the media reported that losses from failed investments and the lack of clarity in Enron's financial reporting were having a negative impact on Enron's ability to secure needed bank loans, contemporaneous rating reports indicated that Enron had sufficient liquidity. For example, on November 1, 2001, Standard & Poor's reported that it "continue[d] to believe that Enron's liquidity position [was] adequate to see the company through the current period of uncertainty, and that the company [was] working to provide itself with an even greater liquidity cushion through additional bank lines and pending asset sales."[233] Moreover, the thrust of the early reports centered on the question of whether Fastow had improperly garnered approximately $30 million in compensation from the related partnerships, a figure that was not material to Enron's viability as a going concern.

Other widely known facts were consistent with the bonds' ratings and the consensus of opinion that Enron would be able to pay the bonds at maturity. Most notable were the numerous media stories about the proposed Dynegy merger. On this news, the quotes for Enron bonds rose close to par before they fell again after the merger agreement was terminated. Many of the registered representatives saw the merger news and resulting rise in the bonds' quotes as positive factors that tempered the contemporaneous negative media reports. Moreover, the positive news about the announced merger continued throughout the relevant period.

[232] CX07.036, at 1.

[233] CX07.037, at 1.

In short, Respondent's registered representatives recommended Enron bonds because the considerable uncertainty surrounding Enron's finances reported by the media had dramatically depressed the bonds' prices thereby creating what both the registered representatives and their customers saw as a short-term buying opportunity. Indeed, many registered representatives sold Enron bonds to family members or purchased them for their own accounts. Contrary to Enforcement's contention, the Respondent registered representatives did not possess "obvious information" that the risk of default for the Enron bonds was materially higher than that which was indicated by the bonds' low investment-grade rating.[234] The registered representatives believed that the bonds would be paid in full when they matured.

The Hearing Panel also rejected Enforcement's argument that the Hearing Panel can infer scienter on the part of the selling brokers from the fact that the Fixed Income Department had set high sales credits on the Enron bonds. As the court in *Bennett v. [Respondent]*[235] wrote in dismissing a private securities class-action suit based on the same facts as alleged here, "[I]t would be folly … to hold that incentives for brokers to sell securities provide a basis for inferring intent to defraud." Under the facts of this case, the Hearing Panel agrees with the court's comment. Particularly here, where Enforcement has not presented any evidence whatsoever connecting the size of the sales credits to ill motive or impropriety, the size of the gross sales credits alone cannot support a finding of scienter on the part of the selling registered representatives. Moreover, as discussed above, Enforcement presented no evidence to show that MK set the higher sales credits to induce the Firm's registered representatives to sell Enron bonds or that the individual registered representatives acted inappropriately because of the

[234] *Cf. Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 SEC LEXIS 687, at *39 (Mar. 19, 2003) (finding scienter established when representative was aware of material information and failed to make appropriate disclosures to customers), *aff'd*, 75 Fed. Appx. 320 (5th Cir. 2003).

[235] [Citation omitted], citing *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002).

higher sales credits. As Respondent's expert witness noted, the payout received by the registered representatives was almost certainly too small to motivate fraudulent conduct.[236] Furthermore, the Hearing Panel noted that in many cases the registered representatives had long-term relationships with their customers who purchased Enron bonds. It is unlikely that the prospect of earning the modest credits involved here would have motivated the registered representatives to engage in sales practices that would jeopardize those relationships.

B. Inequitable Conduct

1. Legal Standard

Conduct Rule 2110 provides that every "member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." Conduct Rule 2110 allows FINRA to regulate broker-dealers under ethical standards as well as legal standards.[237] In determining whether Enforcement has proven a violation of Conduct Rule 2110 in cases in which an associated person's obligations to a customer are at issue, Enforcement need not show that the respondent acted with scienter. Enforcement only need prove that the respondent acted in bad faith or unethically.[238]

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[236] RX-S, at 5.

[237] *See Jones v. SEC*, 115 F.3d 1173, 1182 (4th Cir. 1997) (holding that the Maloney Act of 1938, which authorized the creation of self-regulatory organizations, allowed NASD "to regulate itself by prohibiting and preventing fraud and unethical conduct by its members and by promoting in them professionalism and technical proficiency").

[238] *See Calvin David Fox*, Exchange Act Release No. 48731, 2003 SEC LEXIS 2603 (Oct. 31, 2003); *Department of Enforcement v. Aleksandr Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *13-15 (N.A.C. June 2, 2000) (holding that the concepts of excuse, justification, and bad faith may be employed to determine whether conduct is unethical).

2. Registered Representatives Did Not Act Unethically or in Bad Faith

In the Second Cause of Action, as an alternative to the fraud charge, the Department charged Respondent with negligently omitting to disclose material facts and making material misrepresentations in violation of Rule 2110. The Hearing Panel dismissed this charge as well. The Hearing Panel found that Enforcement failed to prove by a preponderance of the evidence that the registered representatives engaged in unethical conduct or that any registered representative had acted in bad faith in connection with the sales of Enron bonds.

Enforcement's single allegation implicating bad faith was that the registered representatives were improperly motivated by the large sales credits on the Enron Bonds. But, as discussed above, the Hearing Panel found no evidence to show that the sales credits motivated the registered representatives to act in bad faith. In fact, all of the evidence showed just the opposite. The only direct evidence regarding the registered representatives' motivation was their own testimony that they had recommended Enron bonds because they believed the investment to be in the best interest of their customers. Here, at most, the evidence reflected a few isolated instances where a small number of registered representatives erred like much of the rest of the marketplace in assessing the overall severity of Enron's problems. Accordingly, the Hearing Panel concluded that the Second Cause of Complaint must be dismissed because Enforcement failed to show by a preponderance of the evidence that the Respondent registered representatives acted either unethically or in bad faith when they recommended Enron bonds to their customers.[239]

[239] Because Enforcement failed to prove by a preponderance of the evidence that any registered representative engaged in misconduct, the Hearing Panel found it unnecessary to decide whether Respondent could have been found liable for isolated instances of misconduct by individual registered representatives without a further showing (absent here) that Respondent caused their misconduct, or at a minimum knew or had reason to know of the misconduct and acquiesced in it. The Hearing Panel notes that Enforcement failed to cite to a single case in which a member firm was disciplined under such circumstances.

C. Supervisory System and Procedures

1. Legal Standard

Conduct Rule 3010(a) requires each member to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules.[240] Rule 3010(a) requires a member's supervisory system to include certain elements, such as providing for: "[t]he designation … of an appropriately registered principal with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages; … [t]he assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities; and … [r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities."[241] The supervisory system must be tailored specifically to the member's business and must address the activities of all of its registered representatives and associated persons.[242] "Whether a particular supervisory system or set of written procedures is in fact 'reasonably designed to achieve compliance' depends on the facts and circumstances of each case."[243]

Conduct Rule 3010(b) requires each member to establish, maintain, and enforce written supervisory procedures that are reasonably designed to ensure such compliance.[244] A firm's

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[240] *See, e.g., Castle Sec. Corp.*, Exchange Act Release No. 52580, 2005 SEC LEXIS 2628, at *7 (Oct. 11, 2005).

[241] NASD Conduct Rule 3010(a)(2), (5), and (6).

[242] NASD Notice to Members 99-45, 1999 NASD LEXIS 20, at *5 (June 1999).

[243] *Kresge*, 2007 SEC LEXIS 1407, at *27 (quoting *La Jolla Capital Corp.*, 54 S.E.C. 275, 281 & n.15 (1999)).

[244] *See La Jolla Capital Corp.*, Exchange Act Release No. 41755, 1999 SEC LEXIS 1642, at *13 (Aug. 18, 1999); *see also District Bus. Conduct Comm. v. Lobb*, No. C07960105, 2000 NASD Discip. LEXIS 11, at *16 (N.A.C. Apr. 6, 2000) (citation omitted).

written supervisory procedures memorialize a firm's supervisory system; they "describe the actual supervisory system established by the firm to achieve compliance with applicable rules and regulations."[245] Hence, the written supervisory procedures should include a description of the controls and procedures the firm uses to deter and detect improper activity.[246]

2. No Evidence that Respondent's Supervisory System Was Inadequate

In the Third Cause of Action, as supplemented by the Bill of Particulars, Enforcement claimed that Respondent failed to establish and maintain a system to supervise the sales activities of its registered representatives that was reasonably designed to achieve compliance with applicable securities laws, regulations, and rules. Enforcement contended that the specific shortcoming of the supervisory system was that it failed to provide "additional" or "enhanced" supervisory steps to ensure that the customers' interests guided the registered representatives' disclosures in connection with the sales of bonds with "inflated" gross sales credits.[247] In its Post-Hearing Submission, Enforcement stated the system's shortcoming differently, arguing that Respondent's supervisory system lacked "an adequate system of checks and balances to ensure, from a supervisory viewpoint, that the Enron bond situation would have been detected."[248] Nonetheless, under either formulation, Enforcement failed to establish this charge both as a matter of fact and as a matter of law.

First, Enforcement failed to prove by a preponderance of the evidence that the gross sales credits on the Enron bonds were an indication of irregularity that called for supervisory scrutiny. Enforcement rested this entire charge on the false premise that the magnitude of the gross sales

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[245] NASD Notice to Members 98-96, 1998 NASD LEXIS 121, at *6 (Dec. 1998).

[246] *Id.*

[247] *See* Bill of Particulars, at 7-8.

[248] Enforcement's Post-Hearing Submission, at 116.

credits alone dictated a greater degree of supervision of the sales of the Enron bonds. In other words, without reference to any impropriety in the amount of the gross sales credits, Enforcement began its analysis of Respondent's system and procedures with the assumption that the $10 to $15 gross sales credits MK set for the Enron bonds should have been treated as a red flag of improper sales practices. But, Enforcement presented no evidence or authority to support its assumption that gross sales credits of the magnitude involved here were inherently suspect. Furthermore, Enforcement pointed to no rule, regulation, or other guidance restricting gross sales credits on fixed income securities to a level lower than those MK set for the Enron bonds.

Second, Enforcement failed to prove by a preponderance of the evidence that Respondent's supervisory system was not reasonably designed to achieve compliance with applicable securities laws, regulations, and rules by the Firm's sales force in connection with the recommendations and sales of securities to their customers. Respondent's Compliance Manual set forth policies governing customer recommendations, risk disclosures, suitability considerations, and an explanation of particular risks associated with corporate bonds. These policies supplemented the sales practice training received by all Respondent registered representatives. The Compliance Manual detailed in part the following prohibitions and requirements: No Blanket Recommendations; No Recommendations on the Basis of Compensation; Need for Current Information; Suitability Considerations; Balanced Disclosure; General Risk Disclosure; and Specific Bond Risk Considerations.[249] In turn, Respondent's Branch Office Manager Manual specifically assigned the Branch Office Managers responsibility for supervising point-of-sale recommendations by registered representatives. Each registered representative was supervised by a Branch Office Manager, who was responsible for monitoring the activities of registered representatives, sales assistants, and other employees in the branch for

[249] *See* CX03.001.

compliance with applicable laws, rules, and regulations, as well as Respondent's policies and procedures.[250] The Branch Office Managers had primary responsibility for reviewing incoming and outgoing correspondence, new account applications, and sales activities.[251] They also were responsible for monitoring customer accounts for signs of irregular, inappropriate, or unsuitable trading, and they were assigned responsibility for conducting a daily review of each registered representative assigned to his or her branch office using a printout of detailed information about each customer's risk profile, investment objective, net worth, and investment experience as reported by the customer in his or her most recent "Customer Preference Profile."[252] Enforcement presented no evidence that these procedures were unreasonable under the standard of Procedural Rule 3010 although the Hearing Panel had a number of reservations about their implementation and, in particular, the Compliance Department's role in assuring that the procedures were consistently followed.[253]

3. No Evidence that Respondent's Supervisory Procedures Were Inadequate

The Fourth Cause of Action alleges that Respondent failed to establish, maintain, and enforce written procedures to supervise the types of business in which the Firm engaged and to supervise the activities of its registered representatives that were reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Conduct Rules, in violation of NASD Conduct Rules 3010(a)(1) and 2110. Specifically, the Complaint and Bill of Particulars claimed that the Firm's written procedures were inadequate because they

[250] Tr. 2913-14; CX03.002, at 4.

[251] CX03.002, at 4.

[252] *Id.* at 13. *See also* Tr. 2913-17; CX03.002, at 2, 7-42.

[253] *Cf. District Bus. Conduct Comm. v. Lobb*, 2000 NASD Discip. LEXIS 11, at *16-17 (stating that Enforcement does not meet its burden in failure to supervise cases by showing that the respondent is "less than a model supervisor or that the supervision could have been better" under the circumstances).

did not address "the oversight of the acquisition of the [Enron] bonds or of the process by which they were made available to registered representatives at a high sales credit."[254]

The evidence shows, however, that MK and JF did not deviate from the Firm's usual and customary method of doing business in the acquisition and pricing of the Enron bonds. MK acquired the bonds by bid on the open market in the same manner that he acquired any other corporate bond at the time. Contrary to Enforcement's premise, there was nothing unusual about the Enron bond transactions that would have signaled a need for greater oversight than that which JF and TF provided.

Respondent's Fixed Income Department Trading Manual required MK and JF to review all bond orders to ensure that the customer received the most favorable terms reasonably available under the circumstances.[255] In addition, they were required to review "each order, commission, excessive mark up/downs, and execution quality."[256] Further, Respondent's Fixed Income Supervisory Manual detailed the reviews JF was required to undertake.[257] Enforcement presented no evidence to establish that these procedures were insufficient to implement Respondent's supervisory system as it related to the Fixed Income Department. Moreover, with respect to the acquisition and pricing of the Enron bonds, JF testified that he reviewed and approved the gross sales credits on the Enron bonds. Enforcement presented no evidence to refute his testimony.

In short, the Hearing Panel found that Respondent's system and procedures were reasonably designed to achieve compliance with applicable securities laws and regulations, and

[254] Bill of Particulars, at 7-8.

[255] CX03.006, at 4.

[256] *Id.* at 6.

[257] CX03.008.

with applicable NASD rules, as required by Conduct Rule 3010. Accordingly, the Hearing Panel dismissed the Third and Fourth Causes of Action.

V. ORDER

For the reasons set forth above, the Complaint is dismissed.[258]

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Andrew H. Perkins
Hearing Officer
For the Extended Hearing Panel

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