FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RICHARD G. CODY (CRD No. 2794558), Respondent.	Disciplinary Proceeding No. 2005003188901 Hearing Officer – DMF **AMENDED HEARING PANEL DECISION**[1] January 29, 2009

Summary

Respondent violated Rules 2310 and 2110 by recommending transactions in customer accounts that were quantitatively and qualitatively unsuitable for the customers; violated Rule 2110 by sending customers misleading and unapproved account summaries; and also violated Rule 2110 by failing to update his Form U4 in a timely manner to disclose two settlements with customers. For the suitability violations, Respondent is suspended in all capacities for three months and fined $20,000; for the misleading and unapproved account summaries, Respondent is fined $5,000; and for the Form U4 violation, Respondent is fined $2,500. The charge that Respondent violated Rule 2110 by failing to update his Form U4 to disclose a compromise with creditors is dismissed.

Appearances

Paul D. Taberner, Esq., Boston, MA, and Mark P. Dauer, Esq., New Orleans, LA, for Complainant.

Stephen Z. Frank, Esq., Center Harbor, NH, for Respondent.

DECISION

1. Procedural History

On January 14, 2008, the Department of Enforcement filed a seven-cause Complaint against Respondent Richard G. Cody. The Complaint charges that Cody recommended transactions in certain customer accounts that, in various respects, were quantitatively or

[1] The original Hearing Panel Decision has been amended to correct an error in the Conclusion on p.24.

qualitatively unsuitable for the customers, and thereby violated NASD Rules 2310 and 2110.[2] The Complaint also alleges that Cody sent the customers account summaries that were misleading and not approved by Cody's employer, in violation of Rule 2110, and that he failed to update his Form U4 to disclose a compromise with creditors and two settlements with customers, in violation of Rule 2110. Respondent filed an Answer contesting the charges and requesting a hearing, which was held in Boston, Massachusetts, during the period October 27-31, 2008.

2. Respondent

Cody first became registered as a General Securities Representative with Merrill Lynch, Pierce, Fenner & Smith Incorporated in Baltimore, Maryland, in 1996. In September 2000, he moved to Boston and became registered with Salomon Smith Barney Inc., which subsequently became Citygroup Global Markets, Inc. In connection with the move, Smith Barney gave Cody a forgivable loan in excess of $240,000, but his production at Smith Barney did not meet the firm's expectations. In November 2001, he was "permitted to resign" from Smith Barney, and in December 2001 he registered with Leerink Swann & Co. He left Leerink in May 2005; since June 1, 2005, he has been registered with GunnAllen Financial, Inc. (CX 41; Tr. IV at 113-17, 119; Tr. V at 59-60.)[3]

3. Suitability

The suitability charges in the Complaint concern two married couples, RD and LD and JB and EB, who were customers of Cody. RD opened a small account with Cody while he was

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[2] 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 include, where appropriate, NASD. Initially, FINRA adopted NASD's rules and certain NYSE rules, but it is in the process of establishing a consolidated FINRA rulebook. To that end, on December 15, 2008, certain consolidated FINRA rules became effective, replacing parallel NASD and/or NYSE rules, and in some cases the prior rules were re-numbered and/or revised. See FINRA Regulatory Notice 08-57 (Oct. 2008). This Decision refers to and relies on the NASD rules that were in effect at the time of Respondent's alleged misconduct and cited in the Complaint as the basis for the charges against him.

[3] In this Decision, "CX" refers to Complainant's Exhibits; "RX" refers to Respondent's Exhibits; and "Tr. I" through "Tr. V" refers to the hearing transcripts for October 27 (Tr. I), October 28 (Tr. II), October 29 (Tr. III), October 30 (Tr. IV) and October 31 (Tr. V), which are individually page-numbered for each day of the hearing.

associated with Merrill Lynch. Eventually RD and LD had a total of seven accounts with Cody when he was associated with Leerink, in which they held 90% of their liquid assets, but the suitability charges concern only allegedly excessive trading in LD's Individual Retirement Account ("IRA") and a single transaction in the couple's joint account. JB and EB are close, longtime friends of RD and LD, who recommended Cody to them. They opened three accounts with Cody at Leerink, but the suitability charges relate only to trades in JB's IRA.[4] (Tr. I at 48, 53, 239-41; Tr. II at 186, 196; Tr. IV at 151-53.)

A. Alleged Excessive Trading in LD's IRA

LD opened her IRA with Cody at Leerink in October 2002, after she retired. Initially, she funded the account with approximately $143,000 transferred from her employer's 401(k) plan. When she retired, she also took a lump-sum pension, but invested those funds in a managed IRA with a different registered representative at another firm. After a few months, she became unhappy with that representative, and in June 2003 she transferred her investments in that IRA to her Leerink IRA with Cody. As of June 30, 2003, after the transfer, the value of her Leerink IRA was approximately $460,000. It was RD and LD's largest account. (CX 5; Tr. I at 46, 48-49, 52-53, 65, 113-15.)

RD and LD were planning for their retirement. They explained to Cody that beginning in January 2005, they would need about $6,000 per month from their investments. Based on their discussions with Cody, they expected that for the first few years they would be able to realize this amount from the income generated by their investments together with about $20,000 per year in principal, but after about five years, when they would both be eligible for social security, the income from their investments would be sufficient to satisfy their needs without having to

[4] FINRA opened the investigation that led to the Complaint after Leerink notified FINRA that it had received complaints against Cody from the customers. (Tr. II at 185.)

further invade the principal. Cody advised them that these goals were reasonable. (CX 1 at 7; Tr. I at 60-61, 117-18, 175-78.)

LD understood that her IRA would be invested primarily in fixed income securities ("bonds")[5] of high quality and relatively short maturity, while the couple's other accounts, including a managed account in which LD invested a portion of her retirement assets, might be invested in equities and other somewhat riskier securities. According to the account opening documents, LD's objective for the IRA was "long term growth," reflecting her expectation that the income generated by the account would accumulate until 2005, and her risk tolerance was "moderate" ; in contrast, the objectives for the couple's other accounts were "growth/speculation." (CX 4; Tr. I at 54-57, 62-65, 118-20, 124, 131-32, 134-35, 137, 144, 174-76.)

LD was not a sophisticated investor. Prior to her retirement, her primary investment experience was her 401(k) account. LD routinely followed Cody's investment recommendations in her IRA; in fact, she testified credibly that Cody generally placed trades in her account without first speaking to her. In his testimony, Cody first claimed, " I had discussions with the client before every transaction," then acknowledged, "I did not speak to them every single day we actually had a transaction, but each transaction was discussed with the clients prior to making them," then conceded, "I discussed with the clients transactions in the account before they actually happened, not always specific to the particular bond that was bought or sold," and finally, in response to the direct question, "Did you speak to the clients about the trades; I'm

[5] For convenience, the term "bonds" is used in this Decision to refer to all of the fixed-income investments in the customers' accounts, although Cody purchased some other types of fixed-income investments in the customers' accounts as well.

going to buy X, I'm going to sell Y, before you made the trade?" admitted, "No."[6] (Tr. I. at 48-51, 72-73, 75-76; Tr. V at 50, 65-66.)

The Complaint charged that during the period June 2003 through May 2004, after LD transferred her pension funds to her Leerink IRA, Cody recommended and effected quantitatively unsuitable trades in the account. During this period, there were 140 buy or sell transactions in the account, including 84 purchases totaling more than $1.4 million, while the average monthly equity was approximately $421,000. Enforcement offered evidence that gross commissions on the transactions, including markups on principal trades, were more than $36,000, of which Cody received nearly $15,000, and that the annualized turnover rate in the account was 3.40 and the commission-to-equity ratio, expressed as a percentage, was 8.7%, indicating that the account would have to appreciate by that amount just in order to break even.[7] (CX 5-7; Tr. II at 187-95.)

Most of this trading involved what is commonly referred to as "bond swapping." That is, Cody typically purchased bonds, held them in the account for a short period, sold them, and promptly used the proceeds to purchase other bonds. In some cases, Cody purchased mutual funds or equities, including preferred stock, for the account, rather than bonds, but regardless of

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[6] The customers were generally highly credible witnesses. Their answers to questions from Enforcement, Cody's counsel and the Panel were thoughtful, forthright and consistent. They readily admitted having uncertain recollections of certain details, and they acknowledged their failure to exercise diligent oversight over Cody's trading in their accounts. Cody's testimony, on the other hand, was evasive and inconsistent on several topics, and the explanations he offered for his actions were unconvincing. Therefore, where there was a conflict between the customers' testimony and Cody's, the Panel credited the customers' testimony.

[7] In cross-examining the FINRA examiner who prepared schedules showing all the transactions and calculating the commissions, turnover rates and commission-to-equity ratios, Cody's attorney attempted to demonstrate that the schedules were inconsistent in some respects with the customers' account statements, and that in other respects the account statements themselves were incorrect. A comparison of the schedules and the account statements, however, reveals that they appear consistent; the differences in transaction totals between the schedules and the account statements identified by Cody's counsel reflect the treatment of accrued interest in bond purchases and sales. (CX 5-6, 25-26; Tr. IV 107-08.) Furthermore, Cody's counsel failed to demonstrate that any of the statements incorrectly valued any holding in the accounts—while some of the valuations may appear questionable, Cody offered no evidence from other sources showing that they were incorrect. In any event, as discussed below, the Panel did not simply rely upon the examiner's turnover or commission-to-equity calculations, but rather evaluated the level of trading in the account in light of the various factors set forth in Rule 2310.

the type of security in which he invested the account, the pattern of in-and-out trading was consistent. Few positions were held for the long term—a comparison of the account's holdings as of June 30, 2003, with those as of May 31, 2004, shows that the only positions held for the entire period were a single municipal bond holding and two zero-coupon corporate bond holdings. (CX 5-6.)

B. Trading in JB's IRA

JB, who was retired, opened his Leerink IRA with Cody in February 2003. He funded the IRA with a rollover of approximately $380,000 from his former employer's 401(k) plan. According to the account opening documents, his investment objective was "income," his risk tolerance was "low," and his liquid net worth was $950,000. JB's wife, EB, also opened an IRA and a managed account at Leerink through Cody, so the couple had a total of three Leerink accounts—two IRAs with Cody and a managed account. (CX 23a, 23b, 24; Tr. I at 184, 187.)

JB testified that his goal in opening the IRA was to obtain income of approximately $2,000 per month from the account. Cody told JB that realizing $2,000 per month income from the account would not be a problem.[8] (Tr. I at 188-89, 232-33.)

Like LD, JB and EB were not sophisticated investors. Their prior investing experience was primarily in their employers' 401(k) plans. And like LD, JB and EB testified credibly that they relied on Cody's advice and that he placed trades in their IRAs without first consulting them. JB and EB learned of the trades when they received confirmations. (Tr. I at 181-83, 191-92, 242-43, 246-47, 254.)

Enforcement alleged that Cody recommended and effected both quantitatively and qualitatively unsuitable trades in JB's IRA during the period February 2003 through May 2004.

[8] In fact, JB's account statements show that he withdrew somewhat higher amounts from the account, $2,500 per month in 2003, and $2,750 per month in 2004. Although not addressed in JB's testimony at the hearing, this may reflect a difference between JB's gross and net income needs. In any event, the Panel did not find the difference material to the issues presented.

With regard to the former, Enforcement offered an exhibit (CX 27), prepared by an examiner, purporting to summarize the value of, and trading in, JB's IRA during the relevant period, on a month-by-month basis. From those numbers, the examiner had calculated a turnover rate and a commission-to-equity ratio for the account. The exhibit was not admitted in evidence, however, because on cross-examination of the examiner, Cody's counsel demonstrated that some of the listed monthly values, from which the examiner had calculated the turnover rate and commission-to-equity ratio, were erroneous. (Tr. IV at 47-48, 55-56.)

As a result, Enforcement failed to establish either a turnover rate or a commission-to-equity ratio for JB's IRA. Enforcement's evidence did show, however, that during the 16-month period in question there were 109 purchase and sale transactions in JB's IRA, or an average of nearly seven per month, and that total commissions on these trades were almost $42,000, of which Cody received more than $17,000. As with LD's account, a review of JB's account statements reveals that these transactions primarily involved short-term bond swapping, as well as some mutual fund and preferred equities trading. (CX 26; Tr. II at 197-99.)

In addition, Enforcement contends that Cody purchased unsuitable non-investment grade bonds for JB's account. A review of JB's account statements reveals that Cody purchased $45,000 of non-investment grade Ahold Financial USA, Inc. bonds in May 2003, $25,000 of non-investment grade Royal Caribbean Cruises, Ltd. bonds in June 2003 and approximately $37,000 of non-investment grade Calpine Corp. bonds, also in June 2003. The Panel notes that Cody sold the Ahold bonds in September 2003 for a realized gain of approximately $1,000, sold the Royal Caribbean bonds in November 2003 for a realized gain of approximately $300 and

sold the Calpine bonds in July 2003 for a realized gain of approximately $700.[9] (CX 26, 27b; Tr. IV at 103-04.)

Finally, as discussed below, Cody made one large Collateralized Mortgage Obligation (CMO) investment in JB's account that Enforcement alleges was unsuitable.

C. CMO Investments

The Complaint charged that Cody recommended and effected unsuitable CMO investments in JB's IRA and in the joint account of RD and LD. When JB opened his IRA in February 2003 with a rollover of approximately $380,000, Cody immediately invested $86,500 of this amount (23%) in a CMO issued by Credit Suisse First Boston. Cody also invested approximately $31,000 of RD and LD's joint account in the same CMO in February 2003.[10] (CX 9, 25-26.)

The CMO that Cody purchased was described as a "Credit Suisse First Boston Mortgage Securities Corp. IndyMac Manufactured Housing Passthru CTF." It was secured by fixed rate manufactured housing installment sales contracts and installment loan agreements. Cody purchased a mezzanine tranche of the CMO, indicating that it was subordinated to some senior tranches. When Cody purchased the CMO in February 2003, it carried an investment grade rating, but it was subsequently downgraded and its value fell precipitously. (CX 9, 25, 34-35.)

Cody testified that he learned about the CMO from another Leerink representative who had substantial experience with bonds. This representative gave a general description of the

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[9] To support its allegation that Cody purchased unsuitable non-investment grade bonds in JB's IRA, Enforcement relied on a summary exhibit showing the proportion of non-investment grade bonds in the account on a monthly basis. (CX 27a.) This summary was of no value to the Panel, however, because it failed to distinguish bonds that were non-investment grade when purchased from those that were investment grade when purchased, but later downgraded, such as the account's CMO investment. (Tr. II at 203-04; Tr. IV at 74-77; CX 35.)

[10] The customers testified that Cody did not discuss the CMO with them before making the investments, while Cody says he did discuss the CMO with the customers before making the investments. It is unnecessary to resolve this dispute because, even assuming Cody discussed the CMOs with the customers, he concedes he recommended the investments. As a result, pursuant to Rule 2310, he was required to have a reasonable basis for believing that they were suitable for JB's IRA and for RD and LD's joint account.

CMO to all of Leerink's representatives, along with some information from Bloomberg, and recommended that their customers invest in the CMO. Cody asked no further questions, concluding that, based on the information he was given, a CMO investment "[s]eemed like a pretty good idea." According to Cody, in explaining the CMOs to the customers:

> I said, "It's an A-rated bond. It's paying 7 percent. It does mature at this particular time. We believe, actually, the shelf life of the bond is going to be six to seven years. It's supported by mortgages and the reason it could be six to seven years is there is a component to this bond where you could get repayment of principal along with interest and if that happens it would cause the bond to mature sooner than what the date of maturity was."

Cody admitted that he did not explain to the customers, or understand himself, that the CMO he purchased was a mezzanine tranche, or what that signified in terms of risk, and that he did not explain, and was not aware, that the underlying mortgages were for manufactured housing. He acknowledged: "At the time I sold it to them I didn't really look at a CMO to be significantly different than any other bond; obviously, I've learned quite a bit since then and, you know, I do now but, no, not when I sold it." (Tr. I at 76-78, 194, 258; Tr. IV 145-46; Tr. V at 52, 67-69.)

D. Discussion

Rule 2310 requires that, when recommending the purchase, sale or exchange of a security to a customer, a registered representative "have reasonable grounds for believing that the recommendation is suitable for such customer" based on the customer's other securities holdings, financial situation and needs. When a registered representative exercises discretion in effecting transactions for the customer—whether or not such discretion has been given formally—the registered representative is deemed to have recommended the transaction, for purposes of Rule 2310.[11]

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[11] "Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of [FINRA's] rules." Rafael Pinchas, 1999 SEC LEXIS 1754, at *20 n. 22 (Sept. 1, 1999) (citation omitted).

A representative's recommendations may be unsuitable for a customer either because of the characteristics of particular recommended investments—qualitative unsuitability—or because the overall volume of recommended trading is excessive—quantitative unsuitability.[12] Enforcement alleges that Cody recommended and effected transactions that were both quantitatively and qualitatively unsuitable.

Adjudicators often use turnover rates and commission-to-equity ratios as helpful tools in evaluating whether representative-directed trading in a customer's account is quantitatively unsuitable. In this case, Enforcement offered evidence that the turnover rate in LD's account was 3.4 during the one-year period beginning June 1, 2003, and ending May 31, 2004, and that this turnover generated a commission-to-equity ratio of 8.7%, indicating that the account would have had to appreciate that much simply in order to break even. While these figures are substantial, particularly for an account invested primarily in fixed-income securities, they are smaller than those in most reported cases finding excessive trading, and the Panel did not find that, by themselves, these figures were sufficient to establish that the trading in LD's account was quantitatively unsuitable. Furthermore, Enforcement failed to establish the turnover rate and commission-to-equity ratio in JB's account. The SEC has emphasized, however, that there is no "magical per annum percentage" that defines excessive trading; instead, the trading in a customer's account must be examined in light of the customer's investment objectives and the other factors identified in Rule 2310 to determine whether it was quantitatively unsuitable.[13]

In this case, the customers were unsophisticated investors. They were at retirement, the trading involved their IRAs, which the customers intended to serve as primary sources of retirement income, and the IRAs were the customers' largest accounts. LD's investment

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[12] Dep't of Enforcement v. Stein, 2001 NASD Discip. LEXIS 38, at *9-10 (N.A.C. Dec. 3, 2001), aff'd, Exchange Act. Rel. No. 47335, 2003 SEC LEXIS 338 (Feb. 10, 2003).

[13] Gerald E. Donnelly, 52 S.E.C. 600, 603 (1996) (finding excessive trading where the annualized turnover rates were between 3.1 and 3.8).

objective was moderate growth, and her risk tolerance was moderate; more specifically, her goal was to accumulate funds in her IRA from which she could draw income beginning in 2005.[14] JB's objective was immediate income, his risk tolerance was low, and he needed to draw income from his IRA. Both customers understood that their accounts would be invested primarily in bonds as conservative, income-generating investments, and during the periods at issue both deferred to Cody's investment recommendations and allowed him to exercise discretion in investing and trading their accounts.[15]

Under these circumstances, the level of bond trading in these accounts appears, on its face, to be excessive, calling for some coherent explanation from Cody as to why he reasonably believed that it was in his customers' best interest.[16] While some trading of fixed-income securities may be appropriate in a customer's account to improve the quality of the portfolio, increase total return, or address tax issues, a pattern of in-and-out trading over an extended period, as in this case, strongly suggests that the trading was excessive.[17] At a minimum, the registered representative recommending the trades must be able to offer a reasonable explanation for the trades, either as consistent with a credible overall strategy or on a trade-by-trade basis.

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[14] While investment objectives are important, "a broker cannot rely upon a customer's investment objectives to justify a series of unsuitable recommendations that may comport with the customer's stated investment objectives but are nonetheless not suitable for the customer, given the customer's financial profile." Department of Enforcement v. Chase, No. C8A990081, 2001 NASD Discip. LEXIS 30, at *17-18 (N.A.C. Aug. 15, 2001).

[15] The caselaw indicates that to find quantitative unsuitability—but not to find qualitative unsuitability—an adjudicator must find that the registered representative "controlled" the account. The Panel found that, under established standards, Cody exercised "control" over LD's IRA and JB's IRA. See Dep't of Enforcement v. Zaragoza, No. E8A2002109804, 2008 FINRA Discip. LEXIS 28, at *16-17 (N.A.C. Aug. 20, 2008).

[16] Cody argued that it was inappropriate for Enforcement to focus on trading in the accounts during a limited period of time, rather than over the entire life of the accounts, but the SEC has squarely rejected this contention. See Jack H. Stein, Exchange Act. Rel. No. 47335, 2003 SEC LEXIS 338, at *18 n. 30 (Feb. 10, 2003) ("In determining whether a broker has engaged in excessive trading, we are not limited to looking only at the full period that the broker managed the customer's account; rather, it is appropriate for us also to review the trading done over a reasonably abbreviated portion of the entire period").

[17] "'In and out' trading involves 'the sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities.' … A pattern of 'in and out' trading is [a] 'hallmark' of excessive trading." Dep't of Enforcement v. Zaragoza, 2008 FINRA Discip. LEXIS 28, at *6 n. 6, 19 (N.A.C. Aug. 20, 2008) (citations omitted).

During his direct testimony, however, Cody made no attempt to articulate a rationale for his trading, either on an overall or trade-by-trade basis. (Tr. IV 112-266.) Furthermore, when questioned about his trading by the Panel, Cody offered generalizations to the effect that he was trading to grow the value of the accounts and increase their yields, but was unable to offer any specific, colorable explanation of how his trades were designed to achieve those goals. (Tr. V at 42-84.)[18]

Accordingly, the Panel found that Cody's trading in LD's IRA and JB's IRA was quantitatively unsuitable, and therefore violated Rules 2310. A violation of Rule 2310 is also a violation of Rule 2110.

The Panel also found that Cody's purchase of below-investment grade bonds for JB's IRA was unsuitable. JB's stated, and actual, risk tolerance was low, but Cody bought speculative-grade bonds. Although JB did not incur any losses on these bonds, they were qualitatively unsuitable for the account, and by recommending and purchasing them Cody violated Rules 2310 and 2110.

Finally, the Panel found that Cody lacked a reasonable basis for believing that his purchases of CMO investments in JB's IRA and RD and LD's joint account were suitable for the customers. A registered representative cannot have a reasonable basis for believing that an investment is suitable for the customer unless the representative understands the investment.[19]

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[18] As discussed below, when Cody prepared and sent certain account summaries to the customers, he referred to them as "ladders." Bond laddering is a well-recognized bond investment strategy that entails the purchase of bonds with staggered maturities to minimize both interest rate risk and reinvestment risk. See "Smart Bond Investing—Bond Laddering" at SaveAndInvest.org, http://www.saveandinvest.org/microsites/smartbonds/503000.asp. Cody did not, however, claim that his trading was intended to implement a bond laddering strategy or attempt to explain how his trades might have been consistent with such a strategy.

[19] See Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) ("By his recommendation [a registered representative] implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information."); F.J. Kaufman and Co., 50 S.E.C. 164, 168 (1989) ("[I]t is self-evident that a broker cannot determine whether a recommendation is suitable for a specific customer unless the broker understands the potential risks and rewards inherent in that recommendation.").

CMOs are complex investment products, difficult to evaluate and suitable primarily for sophisticated or institutional investors. By his own admission, Cody did not understand the potential risks involved in the CMO investments he recommended, and made no serious effort to obtain such an understanding before recommending the CMO investments to the customers. He simply thought they "seemed like a pretty good idea," and his own description of the information he conveyed to the customers expressed that view without any suggestion of the actual risks inherent in a CMO investment. Furthermore, although JB had indicated in his account opening documents that his risk tolerance was low, Cody invested 22% of JB's IRA in the CMO. The Panel, therefore, finds that by recommending the CMO's, Cody violated Rules 2310 and 2110.

4. Account Summaries

A. Facts

The Complaint alleged that Cody sent RD and LD and JB and EB misleading and unapproved summaries of their account holdings. Beginning in approximately June 2003, Cody sent summary spreadsheets, which he referred to as "ladders," to RD and LD. The couple had requested some assistance from Cody to obtain a clearer picture of all their fixed income holdings and the income they could expect to receive from them. Initially, the ladders simply listed all of the fixed income positions in the customers' accounts. For each position, the ladder showed the identity of the issuer, the interest rate, the "quantity" (i.e. the principal amount), and an amount of income the position would generate. In addition, the ladders included a total figure for all the couple's fixed income holdings, expected income from all positions for each month and for the year, and an "average coupon" figure. Cody explained that these early ladders were intended to be "a list of all … income producing assets. It is a cash flow summary of how much income is being generated over a 12-month period …. It is breaking down by security, what each security [produces] in cash flow." (CX 2; Tr. I at 80-84, 154; Tr. IV at 195.)

In September 2003, Cody began including information on the couple's other holdings in the ladders, including total "market value" figures for each of RD's and LD's other accounts, as well as market values for each of the individual equity positions within those accounts. Most significantly, he listed a "total portfolio" value, arrived at by adding the principal value of the couple's fixed-income holdings and the market value of their other holdings. It is this total portfolio figure that the Complaint alleges was misleading. In July 2004, Cody began including in the ladders the market value, as well as the principal value, of each fixed-income position, and a second total portfolio amount, reflecting the market value, rather than the principal value, of the customers' fixed-income holdings. The Complaint does not allege that the ladders were misleading after Cody added this second total portfolio value. (CX 2; Tr. I at 156-57.)

Cody also sent ladders to JB and EB—separate ladders for each of them, as opposed to the combined ladder he sent to RD and LD. The initial ladders for JB included only information about the fixed-income holdings in his IRA, and the initial ladders for EB included only information about the fixed-income holdings in her IRA. Subsequently, Cody began to include his IRA's cash position in the ladders he sent to JB, and both her IRA's cash position and the market value of her managed IRA account in the ladders he sent to EB, and Cody added these numbers to provide a "total" value on both JB's and EB's ladders. Once again, the Complaint alleges that this "total" was misleading, until Cody modified the ladders to include market values for the fixed-income investments. (CX 21-22; Tr. I at 200-03.)

The Complaint also alleged that the ladders Cody sent to JB and EB, as well as other account summaries he provided to them, contained erroneous information regarding their fixed-income holdings. That is, in a few cases they listed holdings that were not actually in the accounts, incorrect quantities of holdings, or incorrectly indicated that certain bonds had been called. Cody generally acknowledged these errors, but testified that they were honest mistakes,

given the difficulties inherent in creating the documents. (Tr. II at 220-22, 227, 230, 232; Tr. IV at 246-50.)

Finally, the Complaint alleged that Cody failed to obtain required supervisory approval for the ladders before sending them to the customers. Leerink's written supervisory procedures at the relevant time provided:

> All incoming and outgoing written (non-electronic) correspondence (i.e., postal or courier delivery) relating to the investment banking or securities business of the firm will be reviewed by the supervisor of the particular business function or his designee before delivery to a designated person for distribution or transmission. … A notation shall be made on an internal record of the daily review by an authorized supervisor/principal. Copies will be retained by the Chief Compliance Officer, or his designee.

(CX 30 at 11.)

Paula Provenzano, a Leerink employee who worked in compliance at the relevant time, testified that a registered representative such as Cody was required to obtain his supervisor's written approval on each piece of correspondence before sending it. Provenzano testified that on one occasion in the Spring of 2005 she challenged Cody when he was attempting to send a ladder-type document to a customer by facsimile—she was unable to identify the content of the document or the customer more precisely. Cody told her that his supervisor, John McPhee "okay'd these things for him all the time." She allowed Cody to send the fax and then alerted both the head of compliance and McPhee, but heard nothing more. (Tr. II at 8-17, 51-52.)

McPhee, Leerink's retail sales manager, who supervised Cody during a portion of the relevant period, testified that he approved all outgoing correspondence by signing it, and that to obtain his approval a representative was supposed to hand the correspondence directly to him. McPhee also testified that once a form letter to a number of customers had been approved, a representative did not have to obtain approval for subsequent mailings if "[t]here [are] no changes made to it." McPhee testified that Cody would be required to obtain his approval in

each case before sending documents such as the ladders to the customers, and that he would not have approved them. He testified that the only types of account summaries that he let his representatives send to customers were reprints of the customers' account statements or daily position reports generated by Leerink's clearing firm. None of the ladders provided to FINRA by the customers or found in Leerink's records reflected supervisory approval. (CX 2, 21-22, 28-29; Tr. II at 13-18, 127, 129, 137, 140, 145-46, 150-55, 164, 178-79.)

Cody, however, testified that his understanding of Leerink's outgoing correspondence approval procedures was: "What we did do was [whenever] there was any correspondence being sent, we did drop it in a bin in a mailroom. My understanding [was that] compliance reviewed the bin." He denied that he had to take each piece of correspondence directly to his manager to obtain approval, but also testified that when he first sent the ladders to his customers he obtained approval for them from his then-manager, and believed that, having obtained such approval, he could send the ladders thereafter without obtaining approval each time. (Tr. IV at 224-27.)

B. Discussion

The Complaint alleges that the ladders Cody sent to RD and LD

> between approximately September 2, 2003 and July 8, 2004 were misleading because they failed to reflect or contain the actual market value of LD's and RD's holdings, including LD's holdings in [her IRA]. Cody's failure to include the actual market value of their holdings made these statements confusing regarding the actual value of LD's and RD's Leerink accounts.

Similarly, the Complaint alleges that the ladders Cody sent to JB and EB

> between approximately October 6, 2003 and September 28, 2004 were misleading because they failed to reflect or contain the actual market value of JB's and EB's holdings. Cody's failure to include the actual market value of their holdings made these statements confusing regarding the actual value of JB's and EB's Leerink accounts.[20]

The customers testified that they believed, erroneously, that the "total portfolio" amounts listed on RD and LD's joint ladders and the "total" amounts listed on JB's and EB's individual ladders reflected the aggregate market value of their holdings. (Tr. I at 84, 89, 204-05, 207.) In fact, those amounts significantly overstated the aggregate market value of the customers' holdings because the "total portfolio" and "total" amounts reflected the principal amount of the customers' fixed income holdings, rather than their market value. (CX 3, 23.)

Cody testified that in creating the ladders he was merely attempting to respond to the requests of his customers, and the Panel did not find that Cody intentionally sought to mislead the customers about the value of their accounts. But even negligent misrepresentations to customers violate Rule 2110's requirement to "observe high standards of commercial honor and just and equitable principles of trade."[21] The Panel finds that Cody was negligent in providing misleading "total portfolio" values on the ladders he sent to RD and LD during the period September 2003 to July 2004 and "total" values on the ladders that he sent to JB and EB during the period October 2003 to September 2004, and thus violated Rule 2110, as charged. Similarly, although the Panel credited Cody's testimony that the errors on the ladders he sent to JB and EB

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[20] Much of the testimony at the hearing focused on other aspects of the ladders, including the fact that they listed income from zero-coupon bonds that were accumulating, but not paying, interest. The customers testified that these figures misled them about the income they could expect to receive from their bond holdings, while Cody argued that it was appropriate to include interest that the bonds were accruing, even if it was not being paid. Because the Complaint did not allege that the inclusion of purported income from the zero coupon bonds in the ladders was misleading, the Panel found it unnecessary to resolve the issue.

[21] See, e.g., Dep't of Enforcement v. Reynolds, No. CAF990018, 2001 NASD Discip. LEXIS 17, at *44, *47 (N.A.C. June 25, 2001).

reflected honest mistakes, rather than efforts to mislead the customers, negligently including mistaken information on the ladders made them misleading and violated Rule 2110.

With regard to obtaining Leerink's approval to send the ladders, Leerink's written procedures clearly required supervisory approval of all correspondence. While the two Leerink employees who testified, Provenzano and McPhee, offered somewhat inconsistent descriptions of Leerink's procedures for obtaining that approval, Cody had been a registered representative for several years, with several firms, when he sent the ladders and should have recognized that they were important and irregular documents for which he unquestionably needed supervisory approval. Although Cody claimed he obtained approval from his manager when he first sent the ladders, even if this was true, he changed the ladders significantly over time, in particular by adding "total portfolio" amounts to RD and LD's ladders and "total" amounts to JB's and EB's ladders, and should have recognized that with these changes, the ladders required additional review and approval. It is likely that if Cody had sought such approval, he would not have received it, and therefore would not have sent the misleading ladders to the customers. Accordingly, the Panel found that, by failing to obtain supervisory approval for the ladders, Cody violated Rule 2110.

5. Form U4 Disclosures

A. Arbitration Settlement

After Cody left Smith Barney and moved to Leerink in 2001, Smith Barney filed an arbitration claim based on the unpaid balance of the forgivable loan it had made to Cody when he came from Merrill Lynch. Smith Barney obtained an arbitration award against Cody in the amount of approximately $228,000; Cody and Smith Barney subsequently entered into a settlement agreement under which Cody was to pay $180,000 over time to discharge the arbitration award. (CX 32-33; Tr. IV at 119-28.)

Like all registered representatives, Cody is required to keep current the information called for by the Uniform Application for Securities Industry Registration or Transfer (Form U4).[22] It is undisputed that Cody did not amend his Form U4 to disclose his settlement with Smith Barney (Tr. IV at 129), and he argues he was not required to do so. Enforcement acknowledges that Cody was not required to amend his Form U4 to report either the arbitration claim or the award, because the Form U4 does not require disclosure of disputes or arbitrations between registered representatives and member firms. Instead, Enforcement argues that Cody was required to report the settlement of the award he entered into with Smith Barney in response to a Form U4 question asking, "Within the past 10 years … have you made a compromise with creditors, filed a bankruptcy petition or been the subject of an involuntary bankruptcy petition?" Enforcement also acknowledges, however, that it is aware of no prior interpretation or decision by FINRA or any other regulator indicating that this Form U4 question requires disclosure of a settlement such as the one between Cody and Smith Barney.

The Panel finds that Cody was not required to disclose the settlement. Enforcement reads the Form U4 language in question as though it asked about any compromise with ***a*** creditor, but, in fact, it asks about "a compromise with creditor**s**." The distinction is important. Historically, a compromise with creditors was a negotiated arrangement between a debtor and some or all of the debtor's creditors as an alternative to bankruptcy—the sort of arrangement that might now be

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[22] See Article V, § 2(c) of FINRA's By-Laws, which currently provides:

> Every application for registration filed with the Corporation shall be kept current at all times by supplementary amendments via electronic process or such other process as the Corporation may prescribe to the original application. Such amendment to the application shall be filed with the Corporation not later than 30 days after learning of the facts or circumstances giving rise to the amendment. ….

The provision of NASD's By-Laws applicable to Cody at the relevant time was identical in substance.

referred to as a "workout."[23] The Panel notes that the Form U4 question regarding a compromise with creditors also asks about voluntary or involuntary bankruptcy, and concludes that the question did not require Cody to disclose his settlement of an arbitration award with a single creditor. Accordingly, this charge will be dismissed.

B. Settlements with Customers

After Cody left Leerink, RD and LD and JB and EB raised concerns about their accounts, particularly the CMO investments in the accounts, with Leerink managers who contacted them. Ultimately, Leerink arranged a settlement with the customers under which Cody paid RD and LD $20,000 and JB and EB $56,000. (CX 33.) Leerink did not contribute to the settlement, but included a release of any liability to the customers in the settlement documents that the firm prepared and the customers signed.

The Form U4 asks: "Have you ever been the subject of an investment-related, consumer-initiated complaint … which alleged that you were involved in one or more sales practice violations, and which complaint was settled for an amount of $10,000 or more?" Cody concedes that he was required to disclose the settlements with RD and LD and with JB and EB in response to this question. Pursuant to Article V, Section 2(c) of FINRA's By-Laws, Cody was required to amend his Form U4 to make this disclosure "not later than 30 days after learning of the facts or circumstances giving rise to the amendment." Cody signed the settlement agreement with JB and EB on July 27, 2005, and signed the settlement agreement with RD and LD on August 9, 2005, but his Form U4 was not amended to disclose the settlements until September 2007. (CX 33, 41.)

Cody testified that he agreed to the settlement with the customers in part because Leerink's chief compliance officer advised him that, because of the manner in which Leerink had

[23] See, e.g., SEC v. United States Realty & Improvement Co., 310 U.S. 434, 448 (1940); A. Harris & Co. v. Lucas, 48 F. 2d 187 (5th Cir. 1931); In re Republic Ins. Co., 20 F. Cas. 552 (N.D. Ill. 1873); Akron Dry Goods Co. v. Comm'r, 18 T.C. 1143 (1952).

drafted the settlement agreements, he would not have to report the settlements on his Form U4. He believed that if Form U4 reporting were required, Leerink would take care of it, but he did disclose the settlements to his new firm. Cody testified that he did not understand that he was required to report the settlements on his Form U4 until he was so advised by his counsel during FINRA's investigation. He then asked his current firm to update his Form U4, on more than one occasion, but the firm was dilatory. (Tr. IV at 260-64.)

> A registered representative's Form U4 must be kept current at all times by supplementary amendments filed with FINRA within 30 days of learning of facts or circumstances giving rise to the amendment. Article V, Section 2(c) of the FINRA By-Laws. A Form U4 that is inaccurate or incomplete so as to be misleading may be deemed to be conduct inconsistent with just and equitable principles of trade in violation of NASD Rule 2110.

Dep't of Enforcement v. Mathis, No. C10040052, 2008 FINRA Discip. LEXIS 49, at *13-14 (N.A.C. Dec. 12, 2008). Moreover, "the obligation to keep the Form U4 current falls squarely on the registered representative." Id. at *16. Thus, Cody could not simply rely on his former employer, Leerink, or his current employer to determine whether it was necessary to update his Form U4; he should have recognized that the plain language of the Form U4 question required that he disclose that he had settled the customers' complaints. The Panel, therefore, finds that Cody violated Rule 2110 by failing to timely update his Form U4 to disclose the settlements with the customers.[24]

6. Sanctions

Enforcement requested that Cody be barred from associating with any FINRA member in any capacity. The Panel determined, however, that Cody's violations did not warrant such an extreme sanction. Instead, as set forth below, the Panel found that a suspension and fine for the unsuitable transactions, together with smaller fines for the misleading and unapproved account

[24] Enforcement argued that Cody's failure to timely update his Form U4 was willful, but under the particular facts and circumstances presented, the Panel did not find Cody's failure to be willful.

summaries and the failure to promptly update the Form U4, will fully accomplish FINRA's remedial goals.

For suitability violations, the Sanction Guidelines recommend a fine of $2,500 to $75,000 and a suspension of 10 business days to one year, or in egregious cases a longer suspension of up to two years or a bar.[25] For negligent misrepresentations, the Guidelines recommend a fine of $2,500 to $50,000 and a suspension of up to 30 business days. And for non-egregious late filing of Form U4 amendments, the Guidelines recommend a fine of $2,500 to $25,000 and consideration of a suspension of five to 30 business days; in egregious cases they recommend consideration of a suspension of up to two years or a bar. FINRA Sanction Guidelines at 73, 93, 99 (2007).

The Panel did not find Cody's suitability violations egregious. They concerned only two customers, and, except for the CMO purchase in RD and LD's joint account, involved only two of those customers' several accounts. The level of bond trading in those accounts was quantitatively unsuitable, but not egregiously so, and the evidence did not support a finding that Cody was trading in order to enrich himself at the customers' expense. And, apart from the CMO investments, Enforcement's evidence established only three qualitatively unsuitable non-investment grade bond purchases in JB's account, and JB actually realized small gains on each of those investments. Finally, the two CMO purchases appear to have been attributable to Cody's lack of understanding of the risks of those investments and his inappropriate reliance on the recommendation of another representative who he believed was experienced and knowledgeable, and he voluntarily paid restitution to the customers for their losses on those investments.

On the other hand, the Panel found that, while not egregious, Cody's suitability violations were serious. He used his own discretion in trading the accounts; the customers were

[25] The Guidelines recommend essentially the same sanctions for churning or excessive trading violations as for suitability violations. FINRA Sanction Guidelines at 82.

unsophisticated and vulnerable; his trading pattern continued for a year in JB's account and more than a year in LD's account; and, most significantly, Cody has not acknowledged and accepted responsibility for his misconduct. Weighing all these factors, a majority of the Panel concluded that a three-month suspension and a $20,000 fine are appropriate remedial sanctions to ensure that Cody will appreciate the seriousness of his misconduct and will not repeat it.[26]

With regard to the misleading and unapproved account summaries, Cody's conduct was negligent, not intentional or reckless. Enforcement did not allege that the original summaries were misleading, only that they became misleading when Cody combined the principal value of the customers' fixed-income holdings with the market values of their other holdings. Cody later self-corrected this problem by adding market values for the customers' fixed income securities to the ladders. The other errors cited by Enforcement in the ladders that Cody sent to JB and EB appear to have been the result of negligence, rather than deliberate efforts to mislead the customers. Finally, although Cody did not obtain appropriate firm approval for sending the ladders to the customers, this appears to be attributable to Cody's misunderstanding of the firm's procedures, rather than any effort to circumvent them, and in that regard the Panel noted that the two witnesses from Leerink, the former compliance person and the sales supervisor, did not entirely agree on the firm's procedures for reviewing outgoing correspondence. Under these circumstances, the Panel found that a $5,000 fine will fully accomplish FINRA's remedial goals.

Finally, with regard to Cody's failure to update his Form U4 in a timely manner, the Panel noted, with regard to the specific considerations set forth in the Guidelines for such violations, that (1) the information regarding settlements of customer complaints was significant, but (2) Cody's failure to report the settlements did not result in a statutorily disqualified person

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[26] The Hearing Officer, while agreeing with the other Panelists as to the relevant considerations, would have imposed a six-month suspension, believing that such a suspension is required under the facts of this case to remediate Cody's serious misconduct. The Hearing Officer concurs in the fine imposed by the Panel for the suitability violation, as well as the fines imposed for the misleading and unapproved account summaries and the failure to promptly update the Form U4.

becoming or remaining associated with a firm, and (3) it did not result in harm to a registered person, a member firm or any customer. See Dep't of Enforcement v. America First Assocs. Corp., No. E102004092601, 2008 FINRA Discip. LEXIS 27, at *28-30 (N.A.C. Aug. 15, 2008). Accordingly, the Panel found that a $2,500 fine for this violation will fulfill FINRA's remedial goals.[27]

7. Conclusion

Respondent Richard G. Cody violated Rules 2310 and 2110 by recommending quantitatively and qualitatively unsuitable transactions in customer accounts; violated Rule 2110 by sending customers misleading and unapproved account summaries; and also violated Rule 2110 by failing to update his Form U4 in a timely manner to disclose two settlements with customers. For the suitability violations, Respondent is suspended in all capacities for three months and fined $20,000; for the misleading and unapproved account summaries, Respondent is fined $5,000; and for the Form U4 violation, Respondent is fined $2,500. In addition, Respondent is ordered to pay costs in the amount of $7,087.50, which includes a $750 administrative fee and the cost of the hearing transcripts. The charge that Respondent violated Rule 2110 by failing to update his Form U4 to disclose a compromise with creditors is dismissed.

[27] In its pre-hearing submission, Enforcement indicated that it would request restitution for the customers, but it did not do so in its closing argument. Cody paid the customers for their losses on the CMO investments and the evidence is insufficient to establish that they suffered any additional quantifiable losses as a result of Cody's unsuitable trading. Accordingly, the Panel declines to order restitution.

These sanctions shall become effective on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final action in this proceeding, except that if this decision becomes FINRA's final action Respondent's suspension shall begin on Monday, April 6, 2009, and end on Sunday, July 5, 2009.[28]

HEARING PANEL

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By: David M. FitzGerald
Hearing Officer

Copies to: Richard G. Cody *(via overnight and first-class mail)*
Stephen Z. Frank, Esq. *(via electronic and first-class mail)*
Paul D. Taberner, Esq. *(via electronic and first-class mail)*
Mark P. Dauer, Esq. (*via electronic and first-class mail*)
David R. Sonnenberg, Esq. (*via electronic and first-class mail*)

[28] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.