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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. E9B2003033701 Hearing Officer—Andrew H. Perkins **HEARING PANEL REMAND DECISION** August 11, 2010

The Hearing Panel dismissed the Complaint following remand. The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent churned a customer's account, in violation of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110, or recommended and effected excessive trading activity, in violation of NASD Conduct Rules 2310 and 2110 and IM-2310-2.

Appearances

Jonathan M. Prytherch, Woodbridge, NJ, for the Department of Enforcement.

Theodore A. Krebsbach and Katherine M. McGrail, KREBSBACH & SNYDER, P.C., New York, NY, for Respondent.

REMAND DECISION

I. PROCEDURAL HISTORY

This proceeding is before the Hearing Panel on remand from FINRA's National Adjudicatory Council ("NAC") to redetermine liability and, if necessary, the sanctions that should be imposed on Respondent for making excessive, fraudulent trades (including options and

short sales on margin[1]) and unsuitable recommendations in Customer SM's account at Continental Broker-Dealer Corp. ("Continental") during a six-week period beginning in December 2002.

The first cause of the Complaint alleges that Respondent defrauded Customer SM by churning[2] his account, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110. The second cause of the Complaint alleges that Respondent recommended that Customer SM make quantitatively unsuitable trades, in violation of NASD Conduct Rules 2310, 2860(b)(19), and 2110, and NASD Interpretative Memorandum IM-2310-2.

The Department of Enforcement ("Enforcement") filed the Complaint in this proceeding with the Office of Hearing Officers on November 17, 2005, and Respondent filed his Answer on

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[1] As the NAC recognized in its decision, an "option" generally refers to an instrument that provides a right to buy or sell a security at a stated price. The failure to exercise the right after a specified period results in the expiration of the option. A "call option" is a right to buy the underlying stock and a "put option" is the right to sell the underlying stock. A "covered call" refers to a strategy in which an investor writes a call option while at the same time owning an equivalent number of shares of the underlying stock. *See generally* Staff of H. Comm. on Interstate and Foreign Commerce, 96th Cong., 1st Sess. Report of the Special Study of the Options Markets to the Securities and Exchange Commission, at 451-52 (1978) (hereinafter "Special Study of the Options Markets"); LAWRENCE G. MCMILLAN, OPTIONS AS A STRATEGIC INVESTMENT (1980); JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS (Barron's 4th Ed. 1995).

A "short sale" refers to the sale of a security not owned by the seller. Selling short generally is used when the seller believes that the price of the underlying stock will decline or to protect a profit in a long position. The investor essentially borrows the stock at the time of the short sale. If the investor can then buy the stock later at a lower price, the investor will profit from the transaction. *See id.*

[2] "Churning occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interests." *Michael T. Studer*, Exchange Act. Rel. No. 50543, 2004 SEC LEXIS 2347, at *15-16 (Oct. 14, 30, 2004) (quoting *Donald A. Roche*, 53 S.E.C. 16, 22 (1997) (quoting *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981))). It basically involves a broker's deriving profits (commissions) for himself with little regard for the interests of his customer. *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. at 836, 845 (E.D. Va. 1968); *Russell L. Irish*, 42 S.E.C. 735 (1965), *aff'd* 367 F.2d 637 (9th Cir. 1966), *cert denied* 386 U.S. 911 (1967). The SEC has found churning "where: (1) trading in an account was excessive in light of the investment objectives; (2) the broker exercised control over the account; and (3) the broker acted with the intent to defraud or with reckless disregard for the interests of the client." *Donald A. Roche*, Exchange Act Rel. No. 38742, 1997 SEC LEXIS 1283, at *12 (June 17, 1997). The element of scienter differentiates churning from excessive trading.

December 15, 2005, requesting a hearing. Respondent denied that his recommended strategy and trading activity were unsuitable for Customer SM. Respondent contended that Customer SM was an extremely aggressive and speculative investor who approved all of the activity in his account. Respondent also denied that he controlled Customer SM's account although he conceded that Customer SM routinely followed his recommendations and relied on his advice.

The hearing was held in New York City on August 16 and 17, 2006, before a hearing panel comprised of the Hearing Officer, a member of the District 10 Committee, and a member of the District 11 Committee.[3] Enforcement called as witnesses FINRA examiners John Clark and Gregory Marro, Customer SM, and Respondent. Respondent called as witnesses RC of TAI, Respondent's expert on excessive trading calculations, and JR, Respondent's former Continental branch manager. Enforcement offered 19 exhibits at the hearing (CX-1 through CX-19), all of which were admitted. Respondent offered ten exhibits (RX-1 through RX-10), of which nine were admitted into evidence. The Hearing Officer excluded exhibit RX-3, account records for Customer SM's account with GunnAllen Financial, Inc. ("GunnAllen"), which he opened just before he closed the Continental account.

On December 12, 2006, the Hearing Panel issued a decision (the "Hearing Panel Decision") in which it found that Respondent churned Customer SM's account, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110, and made unsuitable recommendations, in violation of NASD Conduct Rules 2310, 2860(b)(19), and 2110, and NASD Interpretative Memorandum IM-2310-2.[4] The Hearing Panel

[3] The same panel members considered the proceeding on remand.

[4] Following the consolidation of NASD and the member regulation, enforcement, and arbitration functions of NYSE Regulation into FINRA, FINRA began developing a new "Consolidated Rulebook" of FINRA Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See FINRA Regulatory Notice 08-57* (Oct. 2008). Because the Complaint in this case was filed before December 15, 2008, the procedural rules that apply are those that existed on December 14, 2008. The conduct rules that apply are those that existed at the time of the conduct at issue. The applicable rules are available at www.finra.org/rules.

Decision rested in large part on the Hearing Panel's credibility determinations. The Hearing Panel barred Respondent from the securities industry and ordered him to pay restitution and costs.

Respondent appealed to the NAC. The NAC reversed the Hearing Panel Decision and remanded the proceeding to the Office of Hearing Officers for the Hearing Panel to reconsider the evidence, including Customer SM's later account records from GunnAllen, and to determine anew if the totality of the evidence supports a finding that Respondent churned Customer SM's Continental account, as alleged in the first cause of the Complaint. The NAC specifically directed the Hearing Panel to determine "whether [Respondent] had *de facto* control over the account because Customer SM was 'unable to evaluate' [Respondent]'s recommendations and was unable 'to exercise independent judgment.'"[5] As part of this review, the NAC further directed the Hearing Panel to address "whether the activity and commissions were so unreasonable in light of the customer's investment objectives and financial situation that they evidence intentional misconduct or recklessness involving an extreme departure from the standards of ordinary care."[6]

In addition, the NAC reversed the Hearing Panel's separate finding under the second cause of the Complaint that Respondent's recommendations with respect to the 55 securities transactions listed in Schedule A to the Complaint, involving equities, short sales of equities, and options, were unsuitable. Enforcement alleged in the second cause of the Complaint that Respondent's recommendations were unsuitable because he made them "without having reasonable grounds for believing that such transactions were suitable for Customer SM in view

[5] *Department of Enforcement v. Respondent*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *42 (July 30, 2009) (the "NAC Decision").

[6] *Id.* at *53.

of the size and frequency of the transactions, the nature of the account and Customer SM's financial situation, investment objectives and needs."[7] Enforcement alleged that Respondent thereby violated NASD Conduct Rules 2310, 2860(b)(19), and 2110, and NASD Interpretative Memorandum IM-2310-2.[8] The NAC concluded that Enforcement did not plead (or prosecute) the case on the theory that the recommended options trades or strategy violated Rule 2860, and, "[t]o the extent that the Hearing Panel relied on such a finding, it is hereby reversed as inconsistent with fair notice requirements."[9]

Following receipt of the NAC Decision, on August 19, 2009, the Hearing Officer held a scheduling conference with the parties and solicited the parties' input as to the procedures that would govern the proceeding on remand. During the conference, the parties indicated that they believed the case could be resolved without further hearings and testimony. Accordingly, the Hearing Officer ordered that the parties file a case plan for resolving this proceeding. Thereafter, the parties entered into certain stipulations,[10] including a stipulation that no further hearings would be held or witness testimony taken. In lieu of further hearings, the parties submitted briefs on November 3, 2009, and reply briefs on November 19 and 24, 2009.

After a thorough review of the record, including Customer SM's GunnAllen account records admitted after the original hearing, the Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that Respondent engaged in excessive, fraudulent trading in Customer SM's Continental account, in violation of Section 10(b) of the Exchange

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[7] Compl. ¶ 20.

[8] *Id.* ¶ 27.

[9] *Department of Enforcement v. Respondent*, 2009 FINRA Discip. LEXIS 7, at *33 n.12.

[10] The parties submitted two sets of stipulations. The first Stipulation dated September 10, 2009, relates to the conduct of the proceeding on remand. In the second Stipulation dated October 1, 2009, the parties agree that Respondent recommended all of the purchases and sales in Customer SM's Continental account.

Act, Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110; or that he recommended quantitatively unsuitable trades to Customer SM, in violation of NASD Conduct Rules 2310 and 2110. Accordingly, the Hearing Panel will dismiss the Complaint.

II. FINDINGS OF FACT

A. Respondent's Background

Respondent has worked in the securities industry since 1998.[11] At the time relevant to this proceeding—December 16, 2002, through February 3, 2003—he was registered with Continental as a general securities representative and a corporate securities representative.[12] Respondent is currently registered with another FINRA member firm.

B. Origin of the Proceeding

In May 2003, Enforcement opened an investigation into whether Respondent had engaged in sales practice abuses regarding Customer SM's account as part of a broader examination of Continental.[13] Clark, a FINRA senior examiner, testified that he participated in the examination of Continental and noticed "red flags" in Customer SM's account.[14] Those red flags included issues regarding possible unsuitable recommendations, excessive commissions, and unsuitable trading strategies involving the use of options.[15] Clark further testified that the red flags Enforcement noticed in Customer SM's account were "consistent with the red flags that [the examiners] were finding on a broader scale in connection with [their] investigation of

[11] CX-1, at 3.

[12] According to the Central Registration Depository System ("CRD"), the Respondent was registered with Continental from December 2000 until January 29, 2004. CX-1, at 4.

[13] Tr. 23, 182.

[14] Tr. 23.

[15] Tr. 23-24.

Continental Broker-Dealer."[16] Clark testified that Continental was expelled from FINRA membership in June 2004 for a wide range of securities violations, including the adoption of an unsuitable options trading strategy designed to generate excessive commissions from customers.[17] The strategy involved simultaneously buying a stock, selling a partial covered call option, and buying a put option, which Respondent called the "Program" (hereinafter the "Continental Options Strategy").[18] Respondent conceded that he employed this strategy for all of his customers who qualified for options trading. At the hearing, Respondent testified that the theory behind the Continental Options Strategy was to generate income on the sale of the calls and to profit from the volatility in the market by covering the calls, purchasing more stock in a rising market, and selling the puts in a falling market.[19] FINRA had found that the Continental Options Strategy was encouraged by the firm's principals and was used systematically throughout most of the firm.[20]

Marro, a FINRA senior examiner, testified that he took part in the sales practice portion of the Continental examination that ultimately led to the charges against Respondent and that he prepared documents for Enforcement regarding the trading activity in Customer SM's account.[21] Marro testified that Enforcement selected Customer SM's account for investigation because it met several of the red-flag criteria Enforcement developed to aid in the Continental examination, including the use of the Continental Options Strategy.[22] Marro further noted several other red

[16] Tr. 23.

[17] T. 24-25; CX-11.

[18] Tr. 23, 179-80, 343-44.

[19] Tr. 319-21. Respondent did not elaborate on how the Continental Options Strategy worked if the market failed to move as he predicted or how the use of margin affected the risk associated with the strategy.

[20] Tr. 25.

[21] Tr. 178-79.

[22] Tr. 182.

flags in Customer SM's account, including active trading, use of margin, a high concentration in particular securities, and a written complaint from Customer SM.[23] Ultimately, this investigation resulted in Enforcement filing the Complaint that initiated this disciplinary proceeding.

C. Trading in Customer SM's Continental Account

Respondent stipulated on remand that he recommended all of the purchases and sales of the securities in Customer SM's Continental account, except the quantity of Acxiom Corp. ("Acxiom") shares he recommended Customer SM sell short on December 20, 2002, and any transactions that resulted from options expirations and margin liquidations.[24] With respect to the Acxiom transaction, Respondent contended that he recommended that Customer SM sell 2500 shares of Acxiom short, but Customer SM insisted on selling 10,000 shares. Customer SM disputed Respondent's account. Respondent also argued that any transactions that occurred due to margin liquidations triggered by Customer SM's inability to pay for the Acxiom transactions or that resulted from options expirations should not be classified as "recommended" transactions. Customer SM routinely followed all of Respondent's recommendations.[25]

In total, there were 55 purchases and sales in Customer SM's account between December 16, 2002, and February 3, 2003, which generated commission charges of $14,227 and margin interest charges of $637.[26] All of the trades were on margin. Continental liquidated the account on February 3, 2003, because Customer SM had not paid for the Acxiom short sale.

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[23] Tr. 182-83.

[24] Stip. (Oct. 1, 2009) ¶ 1.

[25] Tr. 242.

[26] CX-12; *Department of Enforcement v. Respondent*, 2009 FINRA Discip. LEXIS 7, at *59.

D. Customer SM's Investment Objectives and Financial Circumstances

The parties presented conflicting and inconsistent evidence regarding Customer SM's investment objectives and financial circumstances. Customer SM testified that he opened the Continental account with Respondent in November 2002 after he received two cold calls from Respondent or his cold-caller, DK.[27] During the first call, the caller recommended a stock purchase, which Customer SM did not act upon. About a month later, Respondent or DK called back and reminded Customer SM that he would have made money if he had purchased the recommended stock.[28] Following the second conversation, Customer SM decided to open an account with Respondent.

Customer SM testified that he was impressed by what he was told about Respondent's knowledge and experience. Customer SM was told that Respondent had been in the securities business a long time and that he would make a lot of money for him, just as he had done for his other clients.[29] Relying on those representations, Customer SM believed that Respondent would provide him with the expert advice he needed.[30] In addition, Customer SM wanted to open the Continental account because he lacked sufficient time to manage his own account.[31] At the time, he was employed fulltime by an information technology consulting firm.[32] His work entailed consulting with businesses that were implementing business software.[33]

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[27] Tr. 81, 301-02; CX-2.

[28] Tr. 81.

[29] Tr. 83-84.

[30] Tr. 84.

[31] Tr. 83.

[32] Tr. 80; CX-2.

[33] Tr. 84-85, 121-22.

Customer SM had limited investment experience before he opened the Continental account. In about 1998, he opened an online securities account at member firm Morgan Stanley Dean Witter, which then became Harris Direct (hereinafter the "Morgan Stanley Account").[34] Customer SM testified that he used the account to undertake short-term trading, making approximately ten "small trades" per year.[35] Generally, he purchased stock with cash or on margin in lots of between 500 and 1000 shares, and at least some of the share prices were less than $5.[36] On the other hand, Customer SM had no experience with options or short selling, two strategies Respondent recommended and employed in Customer SM's Continental account.[37]

Customer SM claimed that he advised Respondent of his financial circumstances and background when he opened the Continental account. Customer SM told Respondent that he had immigrated to the United States from India 13 years earlier. He was born and educated in India. He earned an undergraduate degree in mathematical statistics and a Masters of Business Administration with a specialization in production and operations management.[38] He told Respondent that he had a wife and two children and was the only family member who earned a living. He stated that he told Respondent that he had three or four years of investment experience, but no experience with options or short selling. He further testified that he told Respondent that his annual income was between $120,000 and $125,000, his total net worth was approximately $200,000, and his liquid net worth was $120,000.[39]

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[34] Tr. 82.

[35] Tr. 82, 98, 112-13.

[36] Tr. 112. Customer SM's Continental account statement for November 2002 reflects that he transferred shares of the following technology companies into the account: Sun Microsystems, Inc., Oracle Systems Corp., Intel Corp., and Atmel Corporation. CX-3, at 6-7. Three of the four stocks were S&P 500 companies.

[37] Tr. 86.

[38] Tr. 80, 123.

[39] Tr. 86-87.

Customer SM's Continental account application indicates that Customer SM's annual net income was between $100,000 and $149,999, his liquid net worth was between $100,000 and $149,999, and his total net worth including their residence was between $1 million and $2,499,999.[40] Customer SM testified that he did not enter the foregoing information; the form was prefilled when he received it from Continental.[41] Customer SM's testimony is corroborated by the letter Continental sent him enclosing the new account form for his signature.[42] The letter states that Continental's Customer Service Department could not reach him by telephone to confirm the information he provided and specifically requests Customer SM to review the information on the form and "make sure it accurately reflects your financial conditions."[43]

Customer SM further testified that the Continental account application contained two errors. He said his total net worth was $200,000, not $1 million to $2.5 million, and that he did not have ten years of investment experience with commodities and options. He testified that he called Respondent when he noticed the errors, but Respondent told him that it was "not important, it is only for the record purposes, and I should not get too concerned about that."[44]

With respect to Customer SM's investment objective, he testified that he told Respondent that his investment objective was "growth and income" and that he cautioned Respondent not to be "overly aggressive."[45] Customer SM's new account application did not contain any

[40] CX-2, at 1.

[41] Tr. 91–94.

[42] RX-6 (Letter from David Meyer, Compliance Analyst, to Customer SM dated Nov. 4, 2002).

[43] *Id.*

[44] Tr. 93-94.

[45] Tr. 88.

information about his investment objectives. The section requesting Customer SM's investment objective was left blank. His options application showed his objective as "income."[46]

Finally, Customer SM testified that he considered the trading Respondent recommended to be inconsistent with his investment objectives of growth and income and that he could not follow and understand Respondent's trading after the second week.[47]

Respondent strenuously disputed Customer SM's testimony and attacked his credibility.[48] On the central issue of Customer SM's investment objective, Respondent testified that Customer SM told him that he was a "short-term trader and he wanted to speculate in the account."[49] Respondent also said that he specifically recalled that Customer SM's GunnAllen new account form showed short-term trading and speculation.[50] However, the Hearing Panel notes that Customer SM did not open the GunnAllen account until after Respondent made the recommended trades at issue so the new account form could not have impacted his opinion regarding Customer SM's investing style. In addition, Respondent claimed that Customer SM told him that he had experience trading options.[51] Again, Respondent said his belief was consistent with Customer SM's GunnAllen account documents although he admitted he had not seen them at the time he recommended options trading to Customer SM.[52] Respondent did not explain how the GunnAllen account documents could have factored into his suitability analysis

[46] CX-2, at 2.

[47] Tr. 100-02.

[48] Respondent's counsel summarized their argument in closing argument as follows, "[Customer SM] might be one of the least credible witnesses you have ever seen. So many of his statements were demonstrably untrue that it would be impossible for me to catalog in the next few minutes without the benefit of his deposition or his transcript of his testimony …." Tr. 531-32.

[49] Tr. 263.

[50] Tr. 263.

[51] Tr. 342-43.

[52] Tr. 315-16.

when they reflected trading that started after the trading at issue in Customer SM's Continental account.

Respondent claimed that he made a "thorough suitability analysis on [Customer SM] and his account, taking into consideration his net worth and his annual income."[53] But his assertion was not supported by other evidence. For example, Respondent testified that his only concern was whether his cold caller and Continental's back office could get a new prospect qualified to enter the "program," which was the Continental Options Strategy.[54] Respondent explained that he limited his review to the customer's on-line profile, which Continental's back-office personnel created from the information on the new account application. Once a new customer was qualified for the "program," Respondent implemented the strategy without any further analysis. Respondent emphasized that he did not need further information from his customers because he considered the strategy to be suitable for all customers.[55] In Customer SM's case, Respondent said that it did not matter whether Customer SM's net worth was $200,000, as he claimed, or $2 million, as Respondent claimed, because in either case Customer SM qualified for the Continental Options Strategy, which Respondent recommended and implemented.[56]

Respondent's claim at the hearing that Customer SM had said his investment objective was speculation was also undercut by Respondent's response to the questionnaire Enforcement sent him in August 2003 pursuant to Rule 8210.[57] The questionnaire asked Respondent, "What did customer [SM] represent his investment objectives to be?"[58] Respondent's attorney drafted

[53] Tr. 264.

[54] *See* Tr. 321-22.

[55] *Id.*

[56] Tr. 373-74.

[57] CX-7, at 8-12. Rule 8210 authorizes FINRA to require members and their associated persons to provide information.

[58] CX-7, at 1.

Respondent's response, which stated in its entirety, "See client account application signed by [Customer SM] attached hereto."[59] By letter dated September 4, 2003, Respondent confirmed that he adopted the responses that his attorney had submitted on his behalf.[60] However, as noted above, neither the new account application nor the options form showed that Customer SM's investment objective was speculation.

The Hearing Panel further notes that Respondent's hearing testimony that he had conducted a thorough suitability analysis on Customer SM and his account, taking into consideration his net worth and his annual income, was irreconcilably at odds with his unequivocal on-the-record interview testimony concerning what he knew about Customer SM. During his on-the-record interview, Respondent testified: (1) he did not know what Customer SM's investment experience was; (2) he did not know Customer SM's age; (3) he did not know what Customer SM did for a living; (4) he was not sure about Customer SM's financial situation; (5) he did not know if Customer SM had any prior investment experience; (6) he did not know where Customer SM had his prior account; (7) he did not know if Customer SM had experience with options; and (8) he did not know if Customer SM had a margin account in the past.[61] When he was asked if there was anything else he remembered about Customer SM, such as the "type of trader he was, or the type of investor he was," Respondent answered "no."[62]

Upon consideration of the foregoing evidence, and having observed the witnesses' demeanor while they testified at the hearing, the Hearing Panel concluded that Customer SM was more credible than Respondent and made findings of fact consistent with that credibility

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[59] *Id.*

[60] *Id.* at 4.

[61] CX-8, at 73-75.

[62] CX-8, at 74.

determination. However, Customer SM's GunnAllen account records require the Hearing Panel to reconsider its prior findings.

E. Trading in Customer SM's GunnAllen Account

The NAC directed the Hearing Panel to consider Customer SM's GunnAllen account records because "a customer's investment experience at another broker-dealer (before, during, and even immediately after the trading at issue), while perhaps not dispositive, could shed light on whether the customer had the ability to understand and make independent decisions about the trading at issue and thus whether the broker had *de facto* control over the account."[63] The NAC further held that Respondent "may use [the GunnAllen account records] both (1) on the issue of whether he had *de facto* control over the account because Customer SM was 'unable to evaluate' [Respondent's] recommendations and was unable 'to exercise independent judgment' and (2) to impeach Customer SM's testimony."[64] Consistent with the NAC's directive, the Hearing Panel reviewed the GunnAllen account records, Respondent's exhibit RX-3.

Customer SM opened a new account at GunnAllen in January 2003, approximately one month before he closed the Continental account. He testified at the hearing that the trading in the GunnAllen account was similar in nature to that at Continental.[65] The GunnAllen documents support his testimony. The records show that, for over one and one-half years at GunnAllen, Customer SM engaged in short-term and options trading.[66] In addition, as in the Continental and Morgan Stanley accounts, Customer SM frequently traded on margin in the GunnAllen account.

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[63] *Department of Enforcement v. Respondent*, 2009 FINRA Discip. LEXIS 7, at *55.

[64] *Id.* at *56.

[65] Tr. 146-47.

[66] RX-3.

The GunnAllen account records also reflect that he approved and understood the trading recommended by his GunnAllen broker.[67]

III. CONCLUSIONS OF LAW

A. Churning—First Cause of Complaint

The first cause of the Complaint charges that Respondent churned Customer SM's account in violation of the antifraud provisions of the securities laws, Section 10b of the Exchange Act, Exchange Act Rule 10b-5,[68] and NASD Rule 2120.[69] "Churning 'occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interests.'"[70] To establish the violation, Enforcement "must prove that the broker-dealer controls the customer account, that trading in the account was excessive in the light of the customer's investment objectives, and that the broker-dealer acted with intent to defraud or with reckless disregard for the customer's interests."[71]

After considering Customer SM's GunnAllen account documents, the Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that the trading in Customer SM's account was excessive in light of his investment objectives. Enforcement has the

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[67] Tr. 147-48.

[68] Section 10(b) of the Exchange Act prohibits the use of "any manipulative or deceptive act or practice" in connection with the purchase or sale of a security, and Exchange Act Rule 10b-5 forbids "any device, scheme, or artifice to defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[69] Enforcement further alleged that Respondent's activities violated Conduct Rule 2110, which requires members and their associated persons to observe high standards of commercial honor and just and equitable principles of trade, and IM-2310-2 (Fair Dealing with Customers), which requires members and their associated persons to deal fairly with members of the public in connection with their sales efforts.

[70] *Michael T. Studer*, Exchange Act. Rel. No. 50543, 2004 SEC LEXIS 2347, at *15-16 (quoting *Donald A. Roche*, 53 S.E.C. 16, 22 (1997) (quoting *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981))).

[71] *Id.* at *16.

burden of proving its claims by a preponderance of the evidence.[72] A "preponderance of the evidence" means the greater weight of the evidence; it is that evidence which, when weighed with that opposed to it, has more convincing force and is more probably true and accurate. If, upon any issue in the case, the evidence appears to be equally balanced, or if it cannot be said upon which side it weighs heavier, then Enforcement has not met his burden of proof.[73]

As discussed above, the GunnAllen account records reflect that Customer SM repeatedly confirmed in writing that his investment objectives were active trading and speculation, and he testified that at all times his investment objectives remained unchanged. Further, the Hearing Panel notes that the trades in the GunnAllen account were quite similar to the trades in the Continental account. When this evidence is weighed together with that concerning the nature of Customer SM's self-directed trading in his Morgan Stanley account before he opened an account with Respondent, the Hearing Panel concludes that there is insufficient proof that the trading activity Respondent recommended was unsuitable and thereby in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110. In addition, the evidence relating to Customer SM's GunnAllen account undermines Enforcement's contention that Respondent had *de facto* control of Customer SM's Continental account. Accordingly, the Hearing Panel will dismiss the first cause of the Complaint.

B. Suitability—Second Cause of Complaint

NASD Conduct Rule 2310(a) provides that, in recommending a purchase of a security to a customer, a broker "shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his

[72] *David M. Levine*, Exchange Act Rel. No. 48760, 2003 SEC LEXIS 2678, at *36 n.42 (Nov. 7, 2003) (holding that preponderance of the evidence is the standard of proof in self-regulatory organization disciplinary proceedings).

[73] *Cf. Kiser v. Dearing*, 2010 U.S. Dist. LEXIS 56582 (E.D. Tex. June 9, 2010).

other security holdings and financial situation and needs." "A broker's recommendations must be consistent with his customer's best interests, and he or she must abstain from making recommendations that are inconsistent with the customer's financial situation. A recommendation is not suitable merely because the customer acquiesces in the recommendation."[74] "A broker's suitability obligation also includes ensuring that a customer understands the risks involved in the investment."[75] In addition, IM-2310-2(a)(1) provides that registered representatives have a responsibility of fair dealing with their customers. A broker violates Conduct Rule 2310 by recommending a level of activity that is inappropriate in relation to the customer's investment objectives.[76]

For the same reasons as discussed above, the Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that the level of activity Respondent recommended was excessive in light of Customer SM's investment objectives. Accordingly, the Hearing Panel also will dismiss the second cause of the Complaint, which alleges that Respondent's recommendations and trades were quantitatively unsuitable and thereby violated NASD Conduct Rules 2310 and 2110.

IV. ORDER

For the reasons set forth above, the Hearing Panel dismisses the Complaint.

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[74] *Dane S. Faber*, Exchange Act Release No. 49,216, 2004 SEC LEXIS 277, at *23-24 (Feb. 10, 2004) (citations omitted).

[75] *Department of Enforcement v. Kesner*, No. 2005001729501, 2010 FINRA Discip. LEXIS 2, at *33-34 (N.A.C. Feb. 26, 2010).

[76] *Jack H. Stein*, Exchange Act Release No. 47,335, 2003 SEC LEXIS 338, at *7 (Feb. 10, 2003); *Paul C. Kettler*, 51 S.E.C. 30, 32 (1992) ("depending on a particular customer's situation and account objectives, the extent of trading alone may render transactions unsuitable").

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Andrew H. Perkins
Hearing Officer
For the Hearing Panel

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