

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF MARKET REGULATION,

Complainant,

v.

Respondent.

Disciplinary Proceeding
No. 2005000171202

Hearing Officer – RSH

HEARING PANEL DECISION

September 20, 2010

The Hearing Panel dismissed the Complaint following a hearing. The Department of Market Regulation failed to prove by a preponderance of the evidence that Respondent recommended and effected unsuitable and excessive trading activity, in violation of Conduct Rules 2310 and 2110 and IM-2310-2.

Appearances

Gerard M. Babendreier, Counsel, Laurie A. Doherty, Counsel, Tina Salehi Gubb, Chief Counsel, and James J. Nixon, Chief Litigation Counsel, for the Department of Market Regulation.

Terrence J. Fleming and Christopher A. Grgurich, Lindquist & Vennum, P.L.L.P., Minneapolis, MN, for Respondent.

DECISION

I. PROCEDURAL HISTORY¹

The sole cause of the Complaint alleges that Respondent violated NASD Conduct Rules 2310 and 2110, and Interpretative Memorandum (“IM”)-2310-2 by recommending a high-yield

¹ As of July 30, 2007, NASD began operating under a new corporate name, the Financial Industry Regulatory Authority (“FINRA”). References in this decision to FINRA include, where appropriate, NASD. On December 15, 2008, certain consolidated FINRA rules became effective, replacing parallel NASD rules, and in some cases the prior rules were re-numbered and/or revised. See Regulatory Notice No. 08-57, FINRA Notices to Members, 2008 FINRA LEXIS 50 (Oct. 2008). This Decision refers to and relies on the NASD rules that were in effect at the time of the Respondent’s alleged misconduct and cited in the Complaint as the basis for the charges against him.

or “junk” bond trading strategy to six customers in four accounts. The Department of Market Regulation (“Market Regulation” or “Department”) alleged that the trading strategy was unsuitable for all of the customers, and resulted in excessive trading in three of the four accounts.

Market Regulation filed the Complaint with the Office of Hearing Officers on August 6, 2009, and Respondent filed his Answer on September 11, 2009. Respondent denied that the strategy and trading he recommended were unsuitable or excessive for his customers. Respondent contended that the strategy was suitable for his customers and that all of them understood and approved of the trading in advance of every transaction. Respondent also argued that his ability to defend himself had been prejudiced by Market Regulation's delay in bringing this case—the Department began its investigation of Respondent in 2004, and by the time of the hearing in 2010, four of Respondent's six customers had died.

The hearing was held in Minneapolis, Minnesota on June 15, 16, and 17, 2010, before a hearing panel composed of the Hearing Officer, and two members of the District 4 Committee. Market Regulation called as witnesses JW (a former broker for some of Respondent's customers), WF (customer VF's son), BA (an accountant who gathered the assets of customers VF and MF after they died), and FINRA examiners Christian Nanu and Kim L. Chung. Respondent testified on his own behalf, but did not call any other witnesses. Market Regulation offered 37 exhibits, Respondent offered 21 exhibits, and the parties offered 15 joint exhibits. All of the exhibits were admitted into evidence.²

After a thorough review of the record, the Hearing Panel finds that Market Regulation failed to prove by a preponderance of the evidence that Respondent violated Conduct Rules 2310

² In this decision, “Tr.” refers to the transcript of the hearing; “CX” to Enforcement's exhibits; “RX” to Respondents' exhibits; and “JX” to the parties' joint exhibits.

and 2110 and IM-2310-2 by recommending qualitatively or quantitatively unsuitable trades to his customers. Accordingly, the Hearing Panel dismisses the Complaint.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Respondent's Background

Respondent first became registered with FINRA as a General Securities Representative in August 1993 through Dain Bosworth in Minneapolis, where he was employed until August 1994. From June 1994 through November 1999, Respondent was employed as a broker at the Minneapolis office of Prudential Securities Incorporated ("Prudential"). From November 1999 through March 2001, he was a broker at the Minneapolis office of UBS PaineWebber ("UBS/PaineWebber"). Between March 2001 and March 2003, Respondent left the securities industry to pursue a music career. By his own account, his attempt at making a living as a musician was "a disaster"; he was not able to support himself, and filed for bankruptcy in November 2003. On March 13, 2003, Respondent re-entered the securities industry as a registered representative of The Oak Ridge Financial Services Group, Inc. ("Oak Ridge") in Golden Valley, Minnesota, where he remains employed.³

B. Origin of the Proceeding

Market Regulation opened an investigation in early 2004 based on Oak Ridge's self-reporting of problems with its TRACE reporting of bond transactions that had taken place between April 1, 2003, and December 31, 2003. In July 2006, Market Regulation sent Respondent a Wells Letter in which it notified him that it had made a preliminary determination that, among other things, he had recommended to customers high-yield bonds that were

³ CX-19, pgs. 2, 8; Tr. 318-321.

unsuitable and executed certain transactions that were excessive.⁴ Ultimately, that investigation resulted in Market Regulation filing the Complaint that initiated this disciplinary proceeding.

C. Violations of Rules 2310 and 2110 and IM-2310-2

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 other security holdings and financial situation and needs.” 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.⁵ A violation of one FINRA rule constitutes a violation of Rule 2110.⁶

In *Department of Enforcement v. Medeck*,⁷ the National Adjudicatory Council (“NAC”) addressed the standards to be applied in determining whether a broker has violated Rule 2310. As the NAC stated in *Medeck*, “There are three main suitability obligations. First, a broker must have a reasonable basis to believe, after performing adequate due diligence, that the recommendation could be suitable for *some* investors (“reasonable-basis suitability”). Second, a broker must have reasonable grounds to believe that the recommendation is suitable for the specific customer at issue (“customer-specific suitability”). Third, a broker must have reasonable grounds to believe that the number of recommended transactions within a particular period is not excessive (“quantitative suitability”).”⁸

⁴ Tr. 182-183; JX-10, pgs. 1, 3, 6-7.

⁵ *Jack H. Stein*, Exchange Act Release No. 47335, 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”).

⁶ *Stephen J. Gluckman*, 1999 SEC LEXIS 1395, at *22 (July 20, 1999).

⁷ 2009 FINRA Discip. LEXIS 7 (N.A.C. July 30, 2009).

⁸ *Medeck*, at *31 (emphasis in original).

To be found liable for excessive trading, a broker must first be found to have had control over the account.⁹ Control can be established either by showing that that broker had discretionary authority or *de facto* control over an account. A broker is deemed to have *de facto* control when the client routinely follows the broker's advice "because the customer is unable to evaluate the broker's recommendations and to exercise independent judgment."¹⁰ In *Medeck*, the NAC added, "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."¹¹

This framework for analyzing a claim of qualitative and quantitative unsuitability was recently reiterated in *Department of Enforcement v. Cody*.¹² In *Cody*, the NAC also made clear that the proper analysis begins with a determination of reasonable-basis suitability because "the reasonableness of any recommendation is predicated on a registered representative's understanding of the potential risks and rewards inherent in that recommendation."¹³

The Complaint in this case charges that Respondent recommended to five customers holding three accounts—VF/MF, DM/MM, and MMc—a trading strategy that was both qualitatively ("customer-specific") and quantitatively unsuitable. Market Regulation alleged that Respondent exercised "effective control" over the three accounts. For customer VM, the Complaint charges only that Respondent recommended a strategy that was qualitatively unsuitable.

⁹ *Department of Enforcement v. Cody*, 2010 FINRA Discip. LEXIS 8, at *32 (N.A.C. May 10, 2010); *Medeck*, at *34.

¹⁰ *Medeck*, at *34.

¹¹ *Medeck*, at *55.

¹² *Cody*, 2010 FINRA Discip. LEXIS 8, at *18-19, *32.

¹³ *Cody*, at *20.

D. High-Yield Bonds (Reasonable-Basis Suitability)

Market Regulation presented essentially no evidence showing that Respondent failed the “reasonable basis” suitability test. The Department produced two witnesses—Nanu and Chung—to testify about the trading in Respondent’s customers’ accounts; however, neither witness testified about the nature of high-yield or “junk” bonds or Respondent’s junk-bond trading strategy. Nanu’s testimony about high-yield bonds was limited to the Standard and Poor’s (“S&P”) ratings definitions; he explained that S&P defines all bonds rated BB+ to D as “Non-Investment Grade, Speculative.”¹⁴

In contrast with Market Regulation’s paucity of evidence about high-yield bonds, Respondent displayed an extensive knowledge of the bonds. Respondent testified that he began selling high-yield bonds in 1994, when he worked at Dain Bosworth, which employed bond traders who taught him about the asset class. He continued to sell high-yield bonds at Prudential before moving to Oak Ridge in 2003.¹⁵ Respondent also studies textbooks written by Edward Altman, a professor of finance at New York University, who Respondent considers “one of the world’s leading authorities on junk bonds.”¹⁶ From his studies, Respondent learned that between 2003 and 2006, the average default rate for all outstanding high-yield unsecured corporate bonds, such as the ones at issue in this case, ranged from 1.25 to 4.66 percent. He also determined that of the high-yield corporate bonds that defaulted between 1974 and 2004, the average recovery for investors was 31 to 42 ½ cents on the dollar of face value.¹⁷ Finally, Respondent testified that while “your conservative, long-term, buy-and-hold investor suffered about a 24 percent loss in

¹⁴ Tr. 215-216; CX-20, CX-37.

¹⁵ Tr. 321-323.

¹⁶ Tr. 323.

¹⁷ Tr. 324-325.

the S&P 500" over the last decade, the Merrill Lynch junk bond index showed an 88 percent gain over the same period.¹⁸

Respondent testified extensively about how he chooses which high-yield bonds to recommend. His starting point for deciding whether to follow a high-yield bond is to look at its Fitch, Moody's and/or S&P rating. Rather than relying exclusively on ratings, however, Respondent examines the financials of select companies, and tracks market and bond trends to obtain detail and insight into the companies. Respondent said that after he reviews a bond's rating, "I move through and do the core of my analysis, which is based on the whole financial picture: research reports, not just research reports on the bonds, but if I can get research reports on the equity, I get insight from that. I have conversations with analysts on the phone. I talk with trading desks both in Minneapolis and in New York, where we trade the bonds through, and draw my own conclusions from my own analysis" He also testified that "I take a close look at all the covenants of the bonds and do a thorough analysis of the financials, take a look at pricing in the market, talk with my bond trader and I take a look at the issue as far as how actively it's traded" At any given time, Respondent follows and may recommend bonds from six to eight issuers.¹⁹

Respondent's attention to detail and tenacity in following the companies whose bonds he recommended are evident in his extensive research files. After Respondent decides to follow a bond, he creates a file into which he puts his research. Respondent explained a sampling of materials from over 1,000 pages of notes, reports, and articles he had compiled on four high-yield bonds he had recommended to some of his customers (Northwest Airlines, Land O' Lakes,

¹⁸ Tr. 326.

¹⁹ Tr. 327-328.

Tenneco Automotive, and Levi Strauss) over a two or three-year period.²⁰ In his Tenneco Automotive file, Respondent explained how he read a Bloomberg “Security Description” report on a Tenneco bond: “This particular bond, it’s in U.S. dollars, it’s senior subnotes, there’s a call date on there, payment dates, and so forth But the thing that really catches my eye right here, and this is something I always look for, ... it says aggregate amount issued, there’s a little box there, aggregate amount issued, 500 million. So, that’s \$500 million face value of these bonds were issued. Below that, aggregate amount outstanding, \$3,860,000 worth outstanding. What that tells me is that this is an issuer that is prepaying their debt before maturity, which is a good sign. It shows that they have the ability to do it, and it shows they’re serious about reducing their debt.”²¹

In addition to financial reports and media articles about the bonds and issuers, Respondent’s files contained handwritten notes of a telephone conversation he had with an S&P analyst in New York who covered Land O’ Lakes. Respondent explained that over the years he had gotten to know bond traders and analysts in New York who would give him additional information and “color” about bonds, bond issuers, and factors which could affect the company.²² For example, Respondent learned from the S&P analyst that Land O’ Lakes’ first quarter earnings were weak, the company was having operational difficulties, had excess capacity at its upper Midwest facilities, and that “fussy customers want cheese sliced thinner and longer.” In his Levi Straus file, Respondent had an e-mail from a partner at an institutional bond house in New York who had sent him an earnings report on Levi Straus.²³ About the e-mail Respondent said, “That was one of the relationships that I cultivated to try to get better

²⁰ RX-13-RX-16.

²¹ Tr. 344.

²² RX-14, p. 5.

²³ RX-16, p. 4.

information on these companies. And so this is what [she] sent me—not that I wouldn't have had it anyway, but trying to get it right to me right away, because she knew that I was interested in Levi.”²⁴

Respondent testified that his strategy was to buy high-yield bonds at a discount from maturity value, realize capital gains, and collect bond interest.²⁵ He said he used a short-to-mid-term active trading strategy because the price of some of the high-yield bonds moved dramatically in a short period of time. He explained that when a bond's price went up sharply, he would sell, take a profit, and purchase another bond that he believed was mispriced or undervalued. He said it was similar to a short to mid-term stock trading strategy, except that the bonds paid interest. He acknowledged that his strategy required him to monitor daily and intraday price fluctuations. Respondent said that he doesn't typically recommend holding high-yield bonds for long periods of time because they are often highly-leveraged, and the longer they are held, the more “things can change,” resulting in a higher risk of adverse changes. He said he explained his strategy to his customers, and indeed, the meticulous files he kept for each customer are replete with notes of discussions he had before each trade.²⁶

Respondent demonstrated an impressive knowledge of the technical details of high-yield bond trading. Market Regulation did not present any evidence to contradict Respondent's rationale for his strategy. The Hearing Panel finds that Respondent had an adequate and reasonable basis for believing that high-yield bonds are suitable for at least some people.

E. Respondent's Customers and the Trading in Their Accounts

Market Regulation argued that the high-yield bonds that Respondent recommended to his customers were unsuitable for them because the bonds were high-risk. The Department

²⁴ Tr. 346-347.

²⁵ Tr. 374.

²⁶ Tr. 419-421; JX-11-JX-14.

contended that because the customers were elderly, their investment objectives were “preservation of principal.” However, Nanu, Market Regulation’s investigator, conceded that none of Respondent’s customers told him that their investment objective was to preserve principal. Nanu further admitted that he knew of no evidence produced during Market Regulation’s seven-year investigation indicating that any of Respondent’s customers had preservation of principal as an investment objective, or that they told Respondent that their investment objective was to preserve principal. Indeed, Market Regulation produced no evidence to show that any of Respondent’s customers had “preservation of principal” as an investment objective. Nevertheless, Nanu testified that he had been directed to analyze the accounts assuming that the customers’ investment objectives were preservation of principal. For that reason, when he conducted a profit and loss analysis of the accounts, he did not include the interest from the bonds that was paid to Respondent’s customers.²⁷ It was only after Respondent’s counsel objected to Market Regulation’s failure to include bond interest, shortly before the hearing, that the Department recalculated profits and losses to include bond interest paid. The revised analyses showed that, rather than combined losses of \$122,000 in the DM/MM, MMc, and VM accounts, as alleged in the Complaint, the combined losses were approximately \$35,000. The VF/MF account had a profit of approximately \$18,423, which was a return of over 30 percent over 17 months.²⁸

²⁷ Tr. 267-271.

²⁸ Tr. 257-267; CX-32-CX-35.

1. The VF/MF Account

a. Suitability

Neither VF nor MF was available to testify, because they had both passed away by the time of the hearing.²⁹ The witness who had had the most contact with VF and MF over the years was Respondent. Respondent testified that he first met VF in 1994 when Respondent was a broker at Prudential. Respondent met with VF in his home and learned that VF was 80 years old, and a retired homebuilder. VF told Respondent that he had been investing “for a long time,” and was interested in high income from the high-yield bonds that Respondent discussed with him. VF indicated that he had a higher risk tolerance for some of his assets. He was reluctant to divulge to Respondent all of his financial information, but said that he held CDs, stocks, annuities, and mutual funds. Shortly after their first meeting, VF opened an account with Respondent and started out “small,” with about \$10,000. Between 1994 and 1999, VF traded primarily high-yield bonds with Respondent.³⁰

When Respondent moved to UBS/PaineWebber in 1999, VF moved his account there. Respondent testified that “around 1999 or so, the high-yield market was getting to be very difficult to find value there, and there were some fee-based money managers that had been producing some pretty good results, and we talked about it and we decided to shift gears and try a new strategy. And, as I recall, we had him in a fee-based growth stock manager over at UBS/PaineWebber.”³¹

In 2001, when Respondent left the securities business to pursue a career in music, JW, another broker at UBS/PaineWebber, took over Respondent's accounts. During the two years Respondent was out of the securities business, he said he stopped by to wish VF and MF merry

²⁹ CX-27 (VF died October 18, 2006, at age 92; MF died August 2, 2004, at age 93).

³⁰ Tr. 352-353.

³¹ Tr. 353-354.

Christmas, and spoke to them a few times, but was too busy with his music to stay in touch much more than that.³²

When Respondent returned to the securities industry in April 2003, he contacted VF and MF. He said they seemed happy to hear from him, and promptly opened a joint account with him at Oak Ridge. They wanted to invest in high-yield bonds again to obtain additional income. They invested \$60,000, which Respondent understood to be about 10 percent of their investable assets. Respondent was aware that they had accounts at other firms, which included mutual funds, and at least one annuity. Respondent filled out their new account forms, and wrote that their investment objectives were “growth and income.” He knew that their risk profile at UBS/PaineWebber had been “moderate,” with a secondary profile of “speculative/aggressive”; however, the Oak Ridge account forms did not contain a place to list a risk tolerance, so he did not include it. Respondent wrote that VF and MF had a net worth of \$500,000, not including their home, and annual income of \$40,000.³³

Respondent testified, credibly, that he had “careful, detailed conversations about [his strategy of trading high-yield bonds]” with both VF and MF. He said, “Nothing ever gets done with any of my client accounts without having those conversations first and getting the client to approve the strategy and the transactions.”³⁴ Indeed, Respondent’s customer file for VF and MF contained notes of his conversations with them, including contemporaneous electronic notes showing that he obtained their authorization for every trade in their account prior to placing the trade.³⁵

³² Tr. 355-356.

³³ Tr. 356-360; JX-1.

³⁴ Tr. 361.

³⁵ JX-11, pgs. 3-41.

Market Regulation's profit and loss analysis of the VF/MF account shows that over a 17-month period, they made 18 purchases of high-yield corporate bonds, which were all sold. Their net profit on their \$60,022 investment was \$18,423—a return of over 30 percent. The vast majority of the trades were profitable; more than half of the loss in the account (\$3,662) was incurred when VF's son took over the account and directed Respondent to sell all of the high-yield bonds.³⁶

Market Regulation presented three witnesses who testified about VF and MF. JW, the UBS/PaineWebber broker who took over Respondent's accounts when he left the securities industry, testified that Respondent accompanied JW to one or two dozen customers' homes to introduce them personally. JW confirmed that VF and MF had an investment objective of "capital appreciation," and that their risk profile was primarily "moderate" and secondarily "aggressive/speculative." He noted that when he received their account, it was worth approximately \$100,000 and contained primarily large cap growth technology and energy stocks.³⁷

Although JW initially stated that VF and MF had only "low" to "moderate" investment experience and sophistication, his assessment was severely damaged on cross-examination. JW stated that the Northwest Airlines high-yield bond that was purchased while JW was handling the account was unsolicited. JW testified that VF called him after the September 11 attacks to ask if he should purchase the bond. JW told him that he did not think he should buy it because of its "junk status"; however, VF insisted, over JW's objection. VF said that he wanted the bond because of the income it provided. JW said that he described the bond and explained the risks associated with it to VF, and admitted that VF "was intelligent enough and had sufficient

³⁶ CX-32.

³⁷ Tr. 43-50.

background to understand it.” JW also admitted that he himself recommended to VF and MF Citigroup preferred trust shares that, upon bankruptcy, would have left them in a worse position than a bond. He said he certainly believed that VF and MF “had sufficient financial wherewithal, sufficient sophistication, and sufficient experience so that they understood the recommendation.”³⁸ Finally, JW admitted that in February 2003, the VF/MF account at UBS/PaineWebber had lost \$34,000 and that those losses might have explained why they transferred their account to Respondent, with whom they had made money in the past.³⁹

WF, VF and MF's son, testified that his father, who had a high school education, didn't have “much sophistication in terms of investments.”⁴⁰ His mother graduated from college and became a physical therapist. WF said his mother had no familiarity with the finances of his father's business, and didn't seem to understand the Oak Ridge account statements.⁴¹ On cross-examination, however, WF admitted that his father never talked about finances with him, and that he had no idea about any of the securities accounts his father had until after VF became ill and WF began helping his mother with the finances. WF then discovered multiple brokerage and bank accounts, which amounted to over \$500,000. WF did not understand the high-yield bonds in his parents' Oak Ridge account, and so directed Respondent to sell all of them and close their account.⁴²

The last person to testify about the VF/MF account was BA, an accountant who is married to VF and MF's granddaughter. BA barely knew VF and MF and had little besides hearsay to provide about their financial acumen or their securities trading. He had never talked to VF about finances or securities. After MF passed away, the family asked BA to summarize

³⁸ Tr. 72-76.

³⁹ Tr. 78-79.

⁴⁰ Tr. 99, 103.

⁴¹ Tr. 103-104, 109.

⁴² Tr. 126-130.

VF's assets so that they could be placed in a trust. In the course of doing that, BA discovered that VF had "10 to 15 separate accounts," including bank and brokerage accounts in which he held securities, CDs, annuities, and mutual funds. BA estimated that the accounts totaled approximately half a million dollars.⁴³

Respondent's version of the facts was corroborated by a letter to Market Regulation that VF signed on January 18, 2005. The letter reads, in part: "I have known [Respondent] since 1994 when he contacted me about investments. I have had many years of experience investing in junk bonds and liked the high returns, even though I realized they were higher risk. My net worth is over \$500,000, [I] am age 90, and I feel junk bonds are suitable for me. [Respondent] has kept me informed and all trades were authorized first by myself or my recently deceased wife Melinda. We have made many changes to the portfolio over time and that has been my objective. [Respondent] is a careful and alert broker who has handled my account well."⁴⁴

Market Regulation asserted, without any evidence, that Respondent had written VF's letter and then coerced VF to sign it. Respondent testified that, after Market Regulation began investigating Respondent's customer accounts, his former attorney suggested that Respondent obtain letters from willing customers. Anticipating Market Regulation's suspicion, Respondent's attorney hired JK, a private investigator, to accompany Respondent when he brought the letter (which Respondent admitted he had drafted), to VF to sign.⁴⁵ According to JK's resume, he is an active member of the Minnesota Bar who retired from the FBI after 27 years as a Special Agent and Supervisory Special Agent. He is now a licensed private investigator employed by a private investigation firm.⁴⁶ JK's written report states, "Respondent told [VF] that the purpose of his

⁴³ Tr. 141-144, 155-159.

⁴⁴ JX-10, pg. 14.

⁴⁵ Tr. 349-351.

⁴⁶ JX-9, pgs. 6-9.

visit was to present him the letter for his signature that they had previously discussed. He presented the letter to [VF] who reviewed it for approximately three minutes. He stated that he understood the letter and that it was accurate. [VF] signed the letter Although elderly, [VF] was alert and appeared lucid. He made decisions and asked questions about the letter. He did not appear confused. I did not observe any actions on the part of Respondent that appeared to be threatening, coercive, intimidating or overbearing. [VF] appeared to be completely at ease and friendly with [Respondent].”⁴⁷

After listening to Respondent's testimony, and observing his demeanor, both during direct examination and cross-examination, the Hearing Panel found Respondent to be forthright and honest. The Hearing Panel therefore found his testimony to be credible. Moreover, Respondent's testimony was, in large part, corroborated by documentary evidence, including his own detailed contemporaneous notes of discussions with his clients, and VF's letter to Market Regulation. In addition, Market Regulation's own witnesses corroborated important parts of Respondent's version of events, even though they disagreed in their assessment of VF and MF's financial sophistication. After weighing all of the evidence, the Hearing Panel finds that Respondent had reasonable grounds for believing that his recommendations to VF and MF were suitable for them, based on the facts they disclosed to him about their other security holdings and financial situation and needs.

b. Control

JW's testimony about VF's unsolicited purchase of a Northwest Airlines high-yield bond, against JW's recommendation, indicates that VF understood and was capable of making his own decision about junk bonds, and was confident enough of his own judgment to disregard his broker's advice. Although the trades in the VF/MF account were solicited, Respondent's

⁴⁷ JX-9, pg. 2.

contemporaneous notes of his conversations with VF and MF provide strong evidence that he discussed every trade and obtained either VF's or MF's authorization before making the transaction.⁴⁸ VF's own letter corroborates Respondent's testimony and the documentary evidence.⁴⁹

The Hearing Panel finds that Respondent did not control the VF/MF account, and therefore finds that the account was not traded excessively.⁵⁰

2. The DM/MM Account

a. Suitability

DM and MM were 82 and 78, respectively, when they opened their account at Oak Ridge on May 20, 2003.⁵¹ They were retired after owning a jewelry store for over 50 years. They listed their assets on their new account form as \$750,000 and their annual income as \$32,000.⁵²

Respondent testified that he first met DM and MM in 1994 or 1995 while Respondent was a broker at Prudential and took over the account from another Prudential broker. Respondent met with DM and MM in their home and, after he explained his strategy for investing in high-yield bonds, they decided to purchase the bonds.⁵³

When Respondent moved to UBS/PaineWebber in 1999, DM and MM moved their account there. Because of the high-yield bond market in 1999, Respondent directed them out of high-yield bonds and into a fee-based growth stock manager at UBS/PaineWebber.⁵⁴

In 2001, when Respondent left the securities business to pursue a career in music, JW took over the DM/MM account, as he had with VF/MF.⁵⁵ JW testified that Respondent

⁴⁸ JX-11, pgs. 3-40.

⁴⁹ JX-10, pg. 14.

⁵⁰ The Hearing Panel noted that the account's annualized turnover ratio (calculated by Market Regulation's analyst), which was 2.296, was not excessive, even if Respondent had controlled the account. CX-45.

⁵¹ JX-3, pgs. 2-3.

⁵² JX-2, pg. 1.

⁵³ Tr. 367-368.

⁵⁴ Tr. 368.

introduced him to DM and MM in their home. JW stated that their level of financial sophistication was “low to moderate,” but confirmed that he did not change the investment objectives or risk tolerance that was recorded on their UBS/PaineWebber account forms. Their investment objective was listed as “capital appreciation,” their primary risk tolerance was “moderate,” and their secondary risk tolerance was “aggressive/speculative.” JW recalled that their net worth in 2001 was approximately \$500,000, but admitted on cross-examination that it was probably over \$1 million.⁵⁶

JW also testified that he had recommended that DM and MM sell the technology stocks in their account, but they refused. He said that DM and MM knew the stocks in the account were “speculative,” but wanted to keep them. He said they were comfortable investing a “small portion of their dollars” in high-risk securities.⁵⁷ JW stated that he believed DM had the “intelligence and experience to understand the recommendations that [JW] was making,” and that she was “competent and understood what [he] was discussing.”⁵⁸

When Respondent returned to the securities industry in April 2003, he contacted DM and MM. He met with them at their home, and they decided to purchase high-yield bonds, as they had at Prudential. Altogether, they invested \$383,000, which came from various other brokerage accounts. They left the bulk of their assets in accounts at other firms.⁵⁹ Approximately \$100,000 was invested with a money manager. Respondent testified, and his contemporaneous notes of a discussion with MM corroborated, that in February of 2004, MM told him that she and DM were dissatisfied with the managed account. She said that they were frustrated because there was too much trading activity, they were receiving trade confirmations almost daily, and they disliked

⁵⁵ Tr. 368.

⁵⁶ Tr. 53-56; JX-3, pg. 4.

⁵⁷ Tr. 91-93.

⁵⁸ Tr. 79-84.

⁵⁹ Tr. 369-371.

not being involved with trading decisions. For those reasons, DM and MM closed that account, which was worth approximately \$100,000, and moved it to their main Oak Ridge account.⁶⁰

Respondent said he believed that DM and MM had approximately 10 to 20 percent of their investable assets with him, and that he thought that was the right amount for diversification of their portfolio.⁶¹ Respondent was aware that they had accounts at other firms, which included mutual funds, and at least one annuity. Respondent filled out their new account forms, and wrote that their investment objectives were “growth and income.” He knew that their risk profile at UBS/PaineWebber had been “moderate,” with a secondary profile of “speculative/aggressive”; however, the Oak Ridge account forms did not contain a place to list a risk tolerance, so he did not include it. Respondent wrote that DM and MM had a net worth of \$750,000 and annual income of \$32,000.⁶²

Respondent testified, credibly, that he had “careful, detailed conversations about [his strategy of trading high-yield bonds]” with both DM and MM. He said, “Nothing ever gets done with any of my client accounts without having those conversations first and getting the client to approve the strategy and the transactions.”⁶³ Indeed, Respondent’s customer file for DM and MM contained notes of his conversations with them, including contemporaneous electronic notes showing that he obtained their authorization for every trade in their account prior to placing the trade.⁶⁴

⁶⁰ Tr. 377-378; JX-13, p. 20.

⁶¹ Tr. 379.

⁶² Tr. 373-376; JX-2, p. 1.

⁶³ Tr. 361.

⁶⁴ JX-13, pgs. 2-40.

Market Regulation's profit and loss analysis of the DM/MM account shows that over a four-year and four-month period, they made 51 purchases of high-yield corporate bonds, which were all sold. They invested a total of \$383,260 over that time and had a net loss of \$8,780.⁶⁵

Respondent's version of the facts was corroborated by a letter to Market Regulation that DM and MM signed on or about January 18, 2005. The letter reads, in part: "We have known [Respondent] since 1994 when our broker at Prudential Securities left and [Respondent] took over our account. We followed him when he moved to PaineWebber in 1999. After he returned to the business in 2003 we transferred our accounts to him at Oak Ridge Financial. [Respondent] has done a good job and we are happy with the service and results We know we own junk bonds and we are comfortable with the higher risk associated with them because of [Respondent]'s experience, monitoring, and careful research. We also know that the current default rate of this asset class is about 3%. We authorized every trade, have a net worth of \$1,500,000 and can afford to take the risk of these investments, which are suitable for us. We understand risk, just as we did when we built a nice jewelry business near Lake Minnetonka, as well as investing over many years with other brokers before we met [Respondent]."⁶⁶

JK's written report states, "We sat at the kitchen table where [Respondent] explained to [MM] that he had drafted a letter for her review and signature in connection with an NASD matter. He requested that she read the letter and sign it if it is accurate. She reviewed the letter for approximately four or five minutes, and then stated that it was accurate and that she would sign it, which she then did...Following the signing of the letter, [Respondent] discussed the portfolio results for the previous year with her. She made a number of inquiries and comments about the portfolio. She stated that her husband was not present because he was in the hospital

⁶⁵ CX-34.

⁶⁶ JX-10, pg. 15.

.... I saw no indication that Mrs. M was confused. I did not observe any activity by [Respondent] that appeared to be threatening, coercive, intimidating, or overbearing.”⁶⁷

Respondent testified that MM later took the letter to DM at the hospital and that he signed it there. He said that either MM mailed the letter back to Respondent, or he picked it up from her a couple of days later.⁶⁸

DM was unable to testify because he had passed away by the time of the hearing;⁶⁹ however, Market Regulation played the videotaped OTRs of DM and MM at the hearing.⁷⁰ Their OTRs were taken on November 9, 2007. MM was alert and cogent during her OTR; however, she did not seem to have an accurate memory of the trading in the account or its profits and losses. She recalled that their assets when they opened their account at Oak Ridge were approximately \$800,000 to \$900,000, in addition to their home.⁷¹ She also recalled clearly that Respondent told her and DM that the high-yield bonds were “a big risk,” and that she had heard of “people losing everything.”⁷² She stated that she did not understand the trading in the account, and relied on Respondent. She also said that she did not read the letter to Market Regulation before signing it.⁷³

DM, who handled most of the trading in the account, was not asked any questions about Respondent, high-yield bonds, or any of the trading in the account, DM was only asked about the 2005 letter he signed. DM said he recognized his signature but said he did not read it, and disagreed with the asset and income figures in the letter.⁷⁴

⁶⁷ JX-9, pg. 2.

⁶⁸ Tr. 380.

⁶⁹ CX-27 (DM died August 26, 2008, at the age of 87).

⁷⁰ CX-1, CX-2.

⁷¹ CX-2, pg. 5.

⁷² CX-2, pg. 5.

⁷³ CX-2, pgs. 6-7.

⁷⁴ CX-2, pgs. 7-8.

The Hearing Panel found the videotapes to be of limited value in assessing DM and MM's understanding of high-yield bonds and the trading in their account. Their testimony, which was not subject to cross-examination, was given over four years after the trading in their account, and they were not shown any of the account documents that might have refreshed their recollections. When MM testified, her husband and daughter were apparently sitting next to her, but off-camera, and could be heard giving her answers to questions when she couldn't remember a fact. In many respects, their testimony conflicted with JW's testimony, Respondent's testimony and contemporaneous notes, and the letter to Market Regulation that they signed in 2005.

After listening to Respondent's testimony, and observing his demeanor, both during direct examination and cross-examination, the Hearing Panel found Respondent to be forthright and honest. The Hearing Panel therefore found his testimony to be credible. Moreover, Respondent's testimony was, in large part, corroborated by documentary evidence, including his own detailed contemporaneous notes of discussions with his clients, and the DM/MM letter to Market Regulation. After weighing all of the evidence, the Hearing Panel finds that Respondent had reasonable grounds for believing that his recommendations to DM and MM were suitable for them, based on the facts they disclosed to him about their other security holdings and financial situation and needs.

b. Control

JW's testimony about DM and MM's refusal to sell their risky technology stocks, even though he advised them to do so, indicates that DM and MM were capable of exercising their own independent financial judgment, and felt confident enough of their judgment to disregard their broker's advice. Although the trades in the DM/MM account were solicited, Respondent's

testimony and his contemporaneous notes of his conversations with DM and MM provide strong evidence that he discussed every trade and obtained either DM's or MM's authorization before making the transaction.⁷⁵ The letter DM and MM signed also corroborates Respondent's testimony and the documentary evidence.⁷⁶

The Hearing Panel finds that Respondent did not control the DM/MM account, and therefore finds that the account was not traded excessively.⁷⁷

3. The MMc Account

a. Suitability

MMc was 70 and divorced when he opened his account at Oak Ridge on June 30, 2003.⁷⁸ He was a retired musician and worked part-time as a music teacher. He listed his assets on his new account form as \$465,000 and his annual income as \$20,000. His investment objectives were listed as "income and growth."⁷⁹

Respondent testified that MMc came to Respondent's office to meet after Respondent had cold-called him. Respondent said that MMc told him that he had invested in securities for many years and had a cash management account at American Express. He told Respondent that in March 2001, after a market drop, he instructed his American Express broker to sell all of his stock funds. The sale was against the broker's advice; however, MMc told Respondent that he was glad he had made the decision to sell. MMc said he was not satisfied with the returns in his American Express account, and so Respondent explained his high-yield bond strategy. MMc

⁷⁵ JX-13, pgs. 3-40.

⁷⁶ JX-10, pg. 15.

⁷⁷ The Hearing Panel noted that the account's annualized turnover ratio (calculated by Market Regulation's analyst), which was 1.118, was not excessive, even if Respondent had controlled the account. CX-45.

⁷⁸ JX-2, pgs. 1-2; JX-12, pg. 21.

⁷⁹ JX-2, pg. 1.

said that he was interested in investing no more than 20 percent of his assets in high-yield bonds.⁸⁰

Respondent testified, credibly, that he had “careful, detailed conversations about [his strategy of trading high-yield bonds]” with MMc. He said, “Nothing ever gets done with any of my client accounts without having those conversations first and getting the client to approve the strategy and the transactions.”⁸¹ Respondent’s customer file for MMc contained notes of his conversations with him, including contemporaneous electronic notes showing that he obtained his authorization for every trade in his account prior to placing the trade.⁸²

Market Regulation’s profit and loss analysis of the MMc account shows that over a three-year period, he made 21 purchases of high-yield corporate bonds, which were all sold. He invested a total of \$82,267 over that time and had a net loss of \$39,476.⁸³

Respondent’s version of the facts was corroborated by a letter that MMc wrote to Market Regulation on or about January 13, 2005. The letter reads: “This letter comes as a “follow-up” to your phone call to me several months ago I am 71 years of age. Net worth approximately \$500,000. Average gross annual income is about \$45,000. I have known [Respondent] for approximately two (2) years. I feel that he is a sincere, honest and trustworthy individual. He did not misrepresent any of the bonds in which I invested. I understand that these are high yield bonds, thus carrying a high risk, and are often referred to as ‘junk bonds.’ [Respondent] keeps me informed of the status of my accounts periodically. He is easily accessible by phone and/or returns my calls promptly. He always answers my questions to my satisfaction. I always feel that [Respondent] is working for me. I feel comfortable with my account with Oak Ridge

⁸⁰ Tr. 383-385.

⁸¹ Tr. 361.

⁸² JX-12, pgs. 2-25.

⁸³ CX-33.

Financial and also feel that these are suitable investments for me at my state of retirement. Let me finally say that [Respondent] is as good a financial agent as any with whom I have dealt.”⁸⁴

JK's written report of his and Respondent's January 18, 2003 visit to MMc's home states, in part, “[Respondent] explained the reason for his visit. [MMc] produced a letter which he said he had drafted and presented it to [Respondent] who read it. [Respondent] said it addressed the areas he requested to be covered. [MMc] asked [Respondent] if he was prepared to go over the annual portfolio review to which [Respondent] replied in the affirmative. [MMc] asked numerous questions about the portfolio performance during the review He was totally lucid I did not observe any activity by [Respondent] that appeared to be threatening, coercive, intimidating, or overbearing. [MMc] appeared to be very comfortable and friendly with [Respondent].”⁸⁵

MMc was unable to testify because he had passed away by the time of the hearing;⁸⁶ however, Market Regulation played the videotape of his OTR at the hearing. The OTR was taken on November 8, 2007.⁸⁷ MMc was alert and cogent during his OTR. His testimony corroborated Respondent's testimony as well as MMc's letter to Market Regulation. MMc testified that he had been investing in securities since approximately 1960, and that Respondent had asked about and obtained information about MMc's financial situation, assets, and investment goals. He said he knew before talking to Respondent that high yield bonds were “risky,” and that Respondent explained the bonds to him. When asked if he remembered the names of any of the bonds in his account, MMc listed the names of six bonds and said there were several more whose names he couldn't recall. Finally, MMc testified that he understood that he

⁸⁴ JX-10, pg. 16.

⁸⁵ JX-9, pgs. 1,3.

⁸⁶ CX-27 (MMc died April 30, 2008, at the age of 74).

⁸⁷ CX-3, CX-4.

could lose all of his money on the bonds, and after his account lost about half of its value, he decided, "that's it, I can't invest anymore, I don't want to risk anymore." At that point, he took the remainder of his funds out of the account.⁸⁸

After listening to Respondent's testimony, and observing his demeanor, both during direct examination and cross-examination, the Hearing Panel found Respondent to be forthright and honest. The Hearing Panel therefore found his testimony to be credible. Moreover, Respondent's testimony was, in large part, corroborated by documentary evidence, including his own detailed contemporaneous notes of discussions with his clients, and MMc's own letter and OTR.

After weighing all of the evidence, the Hearing Panel finds that Respondent had reasonable grounds for believing that his recommendations to MMc was suitable for him, based on the facts MMc disclosed to Respondent about MMc's other security holdings and financial situation and needs.

b. Control

The Hearing Panel found Respondent credible when he related MMc's story of directing his American Express broker to sell his stocks, even against the broker's advice. In addition, once MMc decided that he had "had enough of" losses, he directed Respondent to sell his remaining high-yield bonds. Respondent's testimony, MMc's letter, and MMc's OTR indicate that MMc wanted to try to make extra income from high-yield bonds and was capable of exercising his own independent financial judgment. Although the trades in MMc's account were solicited, Respondent's testimony, his contemporaneous notes of his conversations with MMc,

⁸⁸ CX-4 (transcript of MMc video), pgs. 3-6.

and MMc's letter to Market Regulation provide strong evidence that Respondent discussed every trade and obtained MMc's authorization before making the transaction.⁸⁹

The Hearing Panel finds that Respondent did not control MMc's account and therefore finds that the account was not traded excessively.⁹⁰

4. VM's Account (Only Qualitative Unsuitability Alleged)

Other than her account statements and analysis, Market Regulation presented very little evidence concerning VM. The Hearing Panel accepted into evidence a 16-page excerpt from a transcript of VM's testimony to an arbitration hearing panel. The transcript is dated September 23, 2009, but bears no caption. Most of the questions and answers contain portions which are marked "(inaudible)," rendering the entire transcript virtually unreadable and of no use to the Hearing Panel.⁹¹

In contrast to Market Regulation's lack of evidence, Respondent testified credibly that in April 2004, VM was referred to him by another wealthy customer who had invested over \$1 million in high-yield bonds with Respondent. Respondent said that VM, who was 64 and retired, asked for the same strategy as her friend. Respondent explained the bonds and the risks associated with them, and obtained information about VM's assets, income and investment goals.⁹² He recorded these facts on her Oak Ridge new account form—her net worth was \$250,000, her annual income was \$38,000, and her investment objective was "income."⁹³ As with his other customers, Respondent kept a customer file on VM in which he kept notes of his

⁸⁹ JX-12, pgs. 2-25; JX-10, pg. 16.

⁹⁰ The Hearing Panel noted that the account's annualized turnover ratio (calculated by Market Regulation's analyst), which was 1.411, was not excessive, even if Respondent had controlled the account. CX-45.

⁹¹ CX-5.

⁹² Tr. 389-392.

⁹³ JX-4, pgs. 1-2.

discussions with her. Respondent's notes show that he discussed the high-yield bonds in detail with her, and obtained authorization before every trade.⁹⁴

Market Regulation's profit and loss analysis of VM's account shows that over a twenty-month period, she made 8 purchases of high-yield corporate bonds, all of which were sold. She invested a total of \$70,206 over that time and had a net loss of \$13,726.⁹⁵

After listening to Respondent's testimony, and observing his demeanor, both during direct examination and cross-examination, the Hearing Panel found Respondent to be forthright and honest. The Hearing Panel therefore found his testimony to be credible. Moreover, Respondent's testimony was corroborated by documentary evidence, including his own detailed contemporaneous notes of discussions with VM.

After weighing all of the evidence, the Hearing Panel finds that Respondent had reasonable grounds for believing that his recommendations to VM were suitable for her, based on the facts VM disclosed to Respondent about her other security holdings and financial situation and needs.

IV. CONCLUSION

The Hearing Panel finds that Market Regulation failed to prove by a preponderance of the evidence that Respondent made qualitatively or quantitatively unsuitable recommendations to his customers in violation of Rules 2310 and 2110 and IM-2310-2. The Complaint is therefore dismissed.⁹⁶

⁹⁴ JX-14, pgs. 1-14.

⁹⁵ CX-35.

⁹⁶ Because the Hearing Panel dismissed the Complaint, we do not reach the issue of whether Respondent was unreasonably prejudiced by Market Regulation's delay in filing the case.

IV. ORDER

For the reasons set forth above, the Hearing Panel dismisses the Complaint.⁹⁷

Rochelle S. Hall
Hearing Officer
For the Hearing Panel

⁹⁷ The Hearing Panel has considered and rejects without discussion all other arguments of the parties.