

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

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent.

Disciplinary Proceeding
No. 2005002244102

Hearing Officer - MAD

The Hearing Panel dismissed the Complaint following a hearing. The Department of Enforcement failed to prove by a preponderance of the evidence that Respondent violated NASD Conduct Rules 3010 and 2110 by failing to supervise a registered representative engaged in unsuitable variable annuity exchanges.

Appearances

Gary A. Carleton, Senior Special Counsel, Bradley L. Mirkin, Senior Litigation Counsel, and Danielle I. Schanz, Senior Litigation Counsel, Washington, DC, for the FINRA Department of Enforcement.

Lionel E. Pashkoff, Scott J. Carpenter, and Jacqueline W. Perrell, Proskauer Rose LLP, Washington, DC, for Respondent.

DECISION

I. BACKGROUND AND PROCEDURAL HISTORY

From March to July 2005 (the "Relevant Period"), a former registered representative with ["the Firm"], CKJ, made numerous unsuitable variable annuity exchanges¹ for his retail customers. He made the exchanges shortly after he changed employers and became registered

¹ An "exchange" refers to a tax-exempt exchange of one annuity contract for another under Section 1035 of the Internal Revenue Code. 26 U.S.C. § 1035 (tax exempt status for various exchanges of life insurance, endowment, and annuity contracts).

with the Firm. The unsuitable variable annuity exchanges went undetected by the Firm's Principal Review Desk ("PRD"), the group responsible for reviewing and approving CKJ's transactions. During the Relevant Period, Respondent was the Firm's Chief Compliance Officer ("CCO").

On June 28, 2010, the Department of Enforcement ("Enforcement") filed a four-cause Complaint against CKJ, BB, the Firm's PRD Manager, and Respondent. The Complaint alleged that CKJ, BB, and Respondent violated certain NASD Conduct Rules relating to the sale and supervision of CKJ's variable annuity business. CKJ and BB settled prior to the hearing. Accordingly, the only charge remaining in the Complaint was a single cause of action against Respondent for his failure to supervise CKJ in connection with his variable annuity business, in violation of NASD Conduct Rules 3010 and 2110.²

The hearing was held in Washington, D.C. on August 8-11, 2011, before a Hearing Panel composed of a current member of the District 9 Committee and a former member of the District 3 Committee.³ Enforcement called six witnesses: Respondent; CC, a Regional Compliance Officer at the Firm; CK, an Area Investment Manager (f/k/a Affiliate Sales Manager) at the Firm; PC, a former Brokerage Audit Manager ("Audit Manager") at the Firm; Tracey Angulo, a Principal Investigator with FINRA; and Arturo Norico, Jr., a Forensic Technology Analyst with FINRA. Respondent testified on his own behalf and called HH, the Firm's current president and Chief Executive Officer.

² As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. See Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the conduct rules that were in effect at the time of Respondent's misconduct. The applicable rules are available at www.finra.org/rules.

³ The hearing transcript is cited as "Tr." Enforcement's exhibits are labeled "CX"; Respondent's exhibits are labeled as "RX."

After a thorough review of the record, the Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that Respondent violated NASD Conduct Rule 3010 by failing to supervise CKJ. Accordingly, the Hearing Panel dismisses the Complaint.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Respondent

Respondent has been employed in the securities industry since 1985.⁴ He has been registered with FINRA in a number of capacities since 1987, he became registered as a General Securities Principal in 1988.⁵ Respondent has worked in compliance-related capacities, including as a chief compliance officer at several FINRA member firms.⁶ On January 31, 2005, the Firm hired Respondent as its CCO, and he continues to hold this position.⁷ Respondent reports directly to the Firm's president.⁸ During the Relevant Period, the Firm's president was PPC, who succeeded JM during March 2005.⁹ Respondent also served as a non-voting member of the Risk Management Committee at the Firm.¹⁰ He did not hold any other positions at the Firm.¹¹

B. The Firm

The Firm has been a registered broker-dealer with FINRA since 1939.¹² The Firm is headquartered in [], Ohio.¹³ It is a subsidiary of a large bank, [],¹⁴ and has approximately 2,500 licensed securities personnel.¹⁵

⁴ Tr. 768.

⁵ Tr. 287-88.

⁶ Tr. 295-96, 770.

⁷ Tr. 278, 775.

⁸ Tr. 849. Respondent has two supervisors at the Firm. He reports to the General Counsel of the parent company, [], and the president of the broker-dealer, [the Firm]. *Id.*

⁹ Tr. 876.

¹⁰ Tr. 283.

¹¹ Tr. 283. In July 2005, Respondent became an officer of [the Firm's] parent company. Tr. 493.

¹² CX-4, at 7.

1. The Compliance Department

The Firm's Compliance Department operates separately within the Legal Department of the bank-parent company and independently from the revenue-generating business units of the Firm.¹⁶ Pursuant to the Firm's written supervisory procedures, during the Relevant Period, the Compliance Department had advisory and monitoring functions.¹⁷ Neither the Compliance Department nor Respondent had supervisory responsibilities over the Firm's registered representatives or their supervisors.¹⁸

During the Relevant Period, the Compliance Department at the Firm consisted of 13 individuals, all of whom reported to Respondent.¹⁹ As CCO, Respondent handled a wide variety of compliance-related activities involving the Firm's retail and institutional operations.²⁰ Respondent evaluated the Firm's business units and the effectiveness of his compliance staff during his first several months at the Firm.²¹

2. Supervisory Structure

The Firm has a dual supervisory system.²² Under the first prong, registered principals, designated as affiliate sales managers, supervise the Firm's registered representatives.²³ During the Relevant Period, CK, an Affiliate Sales Manager in the Firm's [], Ohio office, supervised

¹³ CX-4, at 2.

¹⁴ CX-4, at 3.

¹⁵ Tr. 775.

¹⁶ Tr. 49.

¹⁷ RX-5, at 14-15.

¹⁸ Tr. 778.

¹⁹ Tr. 782.

²⁰ Tr. 776.

²¹ Tr. 782.

²² Tr. 783-86.

²³ Tr. 784.

CKJ.²⁴ CK reported directly to the president of the Firm, JM, and later PPC, as did the other affiliate sales managers.²⁵ The affiliate sales managers also had regional compliance officers to assist them.²⁶ During the Relevant Period, CC, a registered principal and a Regional Compliance Officer at the Firm, assisted CK with his supervisory responsibilities.²⁷

The second prong of the Firm's supervisory system is its Principal Review Desk ("PRD"). During the Relevant Period, PRD consisted of approximately six analysts, all of whom were registered principals.²⁸ PRD was responsible for reviewing and approving: (1) new retail account applications; (2) securities transactions; (3) retail securities transactions; and (4) electronic retail correspondence, unless these tasks were specifically designated to another principal supervisor.²⁹ PRD could assess fines and withhold compensation in order to enforce compliance with the Firm's policies and procedures.³⁰ BB was the Manager of PRD.³¹ During part of the Relevant Period, BB reported to the Firm's Product Manager, who supervised PRD and reported directly to the president of the Firm.³² At some point during the Relevant Period, BB reported directly to the president of the Firm.³³

²⁴ Tr. 783, 786.

²⁵ Tr. 783.

²⁶ Tr. 783. The title regional compliance officer was a misnomer. They were not related to the Firm's Compliance Department. Tr. 49, 783. Rather, they provided supervisory support for the affiliate sales managers. Tr. 784.

²⁷ Tr. 142, 538.

²⁸ CX-224.1, at 9; Tr. 785.

²⁹ CX-224.1, at 9; RX-5, at 16. PRD also had its own separate procedures that were incorporated into the Firm's written supervisory procedures. *Id.*; CX-139.

³⁰ RX-5, at 16.

³¹ Tr. 786.

³² Tr. 145, 786; CX-224.1, at 11-12; RX-5, at 16.

³³ CX-224.1, at 11-12.

3. The Audit Department

The Firm's Audit Department consisted of approximately 50-75 individuals.³⁴ It conducted internal audits of various departments, such as PRD and Compliance, as well as audits of other Firm projects and bank operations.³⁵ The Audit Manager created the Firm's internal audit program and supervised all audits.³⁶ During such audits, he directed his communications to the supervisor of the subject audit and Respondent, as the CCO.³⁷ Respondent was involved in the audit process because he was responsible for developing supervisory procedures and compliance guidelines for the Firm.³⁸

The Audit Department conducted an audit of variable annuity sales prior to Respondent's employment at the Firm.³⁹ The audit evaluated PRD's effectiveness with respect to variable annuity suitability reviews and the Firm's policies and procedures.⁴⁰ On February 16, 2005, two weeks after Respondent joined the Firm, the Audit Department provided a draft audit report of the variable annuity sales audit to JM and Respondent.⁴¹ A final version of the audit report was provided to PPC, the current president and ultimate supervisor of PRD, and Respondent on May 2, 2005.⁴²

³⁴ Tr. 703.

³⁵ Tr. 704-07.

³⁶ Tr. 701, 703, 704.

³⁷ Tr. 706, 709-10, 715.

³⁸ Tr. 705.

³⁹ Tr. 354, 707.

⁴⁰ CX-166, at 1.

⁴¹ CX-155. Copies of the report were also provided to BB and the Risk Management Committee. *Id.* at 2.

⁴² CX-166.

The possible rating categories for the audits were satisfactory, needs improvement, and unsatisfactory.⁴³ The Audit Department assigned a "Needs Improvement" rating to the variable annuity sales audit.⁴⁴ The findings stated that: (1) red flags associated with variable annuity transactions were not receiving appropriate attention and follow-up; and (2) the variable annuity supervisory system did not include a clear and consistent suitability standard and exception policy.⁴⁵

The Audit Manager consulted with Respondent during the preparation of his draft and final audit reports.⁴⁶ Respondent also met with BB shortly after joining the Firm.⁴⁷ He understood that the audit findings resulted from PRD's poor recordkeeping rather than its inability to perform suitability reviews.⁴⁸ In response to the audit, Respondent worked with BB to create new policies, which the Firm's Risk Management Committee unanimously approved on June 20, 2005.⁴⁹

C. CKJ's Unsuitable Variable Annuity Exchanges

On January 12, 2005, CKJ transferred his registration as a General Securities Representative from Morgan Stanley DW, Inc. ("Morgan Stanley") to the Firm. At the Firm, CKJ was assigned to the [], Ohio bank branch.⁵⁰ Upon moving to the Firm, CKJ intended to

⁴³ Tr. 349.

⁴⁴ CX-166, at 1.

⁴⁵ CX-166, at 1.

⁴⁶ Tr. 349-50, 356-57, 709-10, 715; CX-150, 155, 166.

⁴⁷ Tr. 786-88.

⁴⁸ Tr. 354-62.

⁴⁹ Tr. 790-91; RX-6, RX-7.

⁵⁰ Tr. 586, 692.

transfer his customers' variable annuities, along with the balance of their assets, from Morgan Stanley to the Firm.⁵¹

In February 2005, shortly after CKJ began submitting the transfer paperwork, he and other Firm personnel learned that the variable annuities held at Morgan Stanley could not be transferred to the Firm because they were proprietary products.⁵² CKJ caused his customers to exchange their variable annuities to a variable annuity product that was available through the Firm in order to continue receiving compensation for the variable annuity contracts held by these customers.⁵³ Specifically, CKJ converted 170 variable annuity contracts into 113 new variable annuity contracts for 74 customers.⁵⁴

The variable annuity exchanges were unsuitable and costly for CKJ's customers.⁵⁵ The customers incurred substantial surrender charges, higher administrative fees, and costs related to additional riders.⁵⁶ Other disadvantages of the new variable annuity included longer surrender periods, higher initial surrender fees, and a higher threshold for withdrawing funds without a penalty.⁵⁷ These costs and disadvantages outweighed the benefits the customers received from the exchange.⁵⁸ Further, when recommending the variable annuity exchanges, CKJ failed to assess each customer's individual needs. Instead, he recommended that they purchase the same

⁵¹ CX-82. CK also planned on CKJ transferring his book of business to the Firm. Tr. 549-65, 599-600; CX-83, CX-85.

⁵² Tr. 557, 568; CX-85; CX-224.2, at 14.

⁵³ Tr. 568-70; CX-224.2, at 14.

⁵⁴ CX-129.

⁵⁵ Prior to the filing of the Complaint, the Firm settled with Enforcement by entering into an Acceptance, Waiver and Consent, which included a violation of NASD Rule 3010 relating in part to the unsuitable variable annuity sales at issue. CX-229. The Firm's sanctions included, but were not limited to, a \$1.75 million fine, payment of restitution to the affected variable annuity customers, and an undertaking to allow the customers to rescind their variable annuity contracts. *Id.*

⁵⁶ CX-127, 135, 136.

⁵⁷ CX-133, 134, 135.

⁵⁸ See CX-133-136.

variable annuities with the same riders, regardless of the customers' ages, incomes, and investment needs.⁵⁹

For each of the variable annuity exchanges, CKJ made misrepresentations and omissions of material facts by providing improperly completed Sales Data Sheets ("SDS") and Explanation of Investment ("EOI") forms to his customers and the Firm.⁶⁰ On the SDS and EOI forms, which were reviewed and signed by the customers, CKJ either misstated or omitted the remaining surrender periods and charges for the variable annuity contracts the customers held at Morgan Stanley.⁶¹ In addition, CKJ falsely identified each customer's investment objectives.⁶² CKJ also improperly completed the SDS and EOI forms required for these exchanges by: (1) failing to explain why switching variable annuities was more advantageous than holding the existing variable annuities;⁶³ and (2) labeling the transactions as unsolicited, when in fact he solicited each customer.⁶⁴

D. Concerns Regarding CKJ's Variable Annuity Exchanges

CK and BB became concerned about the volume of the exchanges in mid-March 2005, when CKJ began submitting his variable annuity transactions for review and approval.⁶⁵ Both questioned whether the exchanges were necessary and suitable for each customer.⁶⁶ As such, CK instructed BB to have PRD review each of CKJ's variable annuity exchanges on its own merits

⁵⁹ CX-52, 53, 54, 132.

⁶⁰ *See generally* CX-118.

⁶¹ CX-52, 53, 54, 116, 118.

⁶² Tr. 117; CX-52, 53, 54, 115.

⁶³ CX-52, 53, 54, 118.

⁶⁴ Tr. 117; CX-52, 53, 54, 115.

⁶⁵ CX-174.

⁶⁶ *Id.*

and asked CKJ to work closely with PRD.⁶⁷ Additionally, when BB detected that many of CKJ's new account forms were incomplete, CC agreed to speak with CKJ and his assistant to review how to properly complete the new account forms.⁶⁸

In late April 2005, CK contacted BB regarding the review and approval of CKJ's variable annuity exchanges.⁶⁹ BB reassured CK that PRD was reviewing every variable annuity exchange and that all approved transactions were within the Firm's guidelines.⁷⁰ In addition, CKJ informed CK that PRD had been contacting him approximately once a week to discuss various exchanges.⁷¹ Nonetheless, even though PRD approved the exchanges, CK instructed CC to review every exchange CKJ submitted.⁷²

On May 10, 2005, upon completing his review of CKJ's exchanges, CC informed CK that every EOI and SDS form stated that the customer did not pay a surrender charge.⁷³ However, when CC contacted the old variable annuity insurance company, he learned that, in all likelihood, the customers were assessed a surrender charge.⁷⁴ Because each of the variable annuity products in question was proprietary to Morgan Stanley, the insurance company would not provide specific information on any of the variable annuity transactions at issue.⁷⁵ Accordingly, CK directed CC to follow-up with PRD and CKJ.⁷⁶ During the next two weeks,

⁶⁷ *Id.*

⁶⁸ CX-175.

⁶⁹ CX-236, at 1.

⁷⁰ *Id.*

⁷¹ *Id.* at 3.

⁷² *Id.* at 2.

⁷³ *Id.* at 5; CX-179.

⁷⁴ Tr. 105; CX-236, at 5.

⁷⁵ CX-224.2, at 15.

⁷⁶ CX-236, at 5.

CK, BB, and CC spoke with CKJ and received conflicting information regarding his failure to disclose the surrender charge on the forms.⁷⁷

On May 17, 2005, CK, BB, CC, and two analysts from PRD participated in a conference call regarding the issues pertaining to CKJ's exchanges.⁷⁸ Although they previously stated their concerns about suitability and the completeness of CKJ's paperwork, their discussion centered on whether CKJ disclosed the surrender charge to his clients.⁷⁹ In order to resolve the possible lack of disclosure, they discussed correcting either the SDS or EOI, or both forms, and returning them to the clients for their acknowledgement of the surrender charge.⁸⁰ BB told the group that he would discuss the matter with Respondent and report back.⁸¹ On May 18, 2005, after he contacted Respondent, BB reported that "[Respondent] agree[d] with our suggested course of action."⁸²

E. Respondent's Recommendations Regarding CKJ's Variable Annuity Exchanges

After Respondent's initial call with BB on May 18, 2005, he requested a follow-up call with CK and BB.⁸³ CK and BB informed Respondent that CKJ had initiated approximately 100 variable annuity exchanges since joining the Firm in early January 2005, all of which had been approved by PRD.⁸⁴ They explained that the SDS and EOI forms both required the disclosure of surrender charges associated with the exchange; however, none of CKJ's variable annuity

⁷⁷ CX-236, at 11-13; CX-237, at 5; CX-224.2, at 65-66.

⁷⁸ CX-236, at 8; CX-237, at 6.

⁷⁹ CX-236, at 6; CX-224.2, at 65; CX-237, at 6.

⁸⁰ CX-237, at 6; CX-224.2, at 65.

⁸¹ CX-237, at 6; CX-194; CX-195.

⁸² CX-195, at 1.

⁸³ Tr. 406.

⁸⁴ Tr. 421, 870. Respondent understood that the exchanges were completed. Tr. 424. Neither BB nor CK told Respondent that CKJ was submitting additional exchanges for review and approval. Tr. 423-24.

transactions reflected a surrender charge when in fact the customers had been assessed a charge.⁸⁵

Each of the variable annuity exchanges also had a bonus feature whereby the new variable annuity company would provide additional funds to the customers for exchanging their old variable annuity product for the new one.⁸⁶ CK reported that CKJ verbally informed his clients of the surrender charge.⁸⁷ CKJ had told BB that he believed that he could put zero on the forms because the bonus covered the surrender charge expense.⁸⁸ CK told Respondent that he would follow his recommended course of action, including correcting both forms if necessary.⁸⁹

Respondent inquired if the Firm had received any customer complaints, and CK and BB reported that there had been none.⁹⁰ In response, Respondent recommended the following course of action: (1) every customer should receive a corrected EOI and sign or initial the surrender charge on the corrected form; (2) at least 10% of CKJ's customers should be called to confirm whether CKJ informed them of the surrender charge; and (3) if any customer noted a problem, the sample should be expanded up to 100% of CKJ's affected customers.⁹¹ They also discussed the type of questions to ask the customers and concluded that open-end, broad-based questions would allow for a better dialogue with the customers.⁹²

⁸⁵ Tr. 378, 405, 414, 466, 841, 869, 870.

⁸⁶ Tr. 828.

⁸⁷ Tr. 419, 430.

⁸⁸ CX-224.2, at 65-66.

⁸⁹ Tr. 432-34.

⁹⁰ Tr. 418. The lack of customer complaints was significant to Respondent because he believed that the old variable annuity company sent their former customers a statement reflecting the surrender charge. Accordingly, if CKJ's customers had not been informed of the surrender charge, there would likely be customer complaints. Tr. 483. CC and BB also thought that the former variable annuity company sent statements to the customers apprising them of the surrender charge. CX-224.2, at 51; CX-203.1, at 2.

⁹¹ Tr. 434, 437, 439-40.

⁹² Tr. 440-41.

After Respondent's conference call with CK and BB, he called BB to discuss CKJ's transactions with him one-on-one.⁹³ Respondent offered to review each of CKJ's exchanges,⁹⁴ but BB declined Respondent's offer and stated that he had personally reviewed the exchanges and conducted suitability reviews.⁹⁵ BB also emphasized that the new variable annuity appeared to be a better product than the variable annuity previously held by CKJ's customers.⁹⁶

On May 19, 2005, JM also learned of the issue regarding CKJ's variable annuities. JM had contacted CK because he was working on the Firm's sales contest, and CKJ was a finalist.⁹⁷ CK informed JM that CKJ did not fill in the surrender charge on the EOI and SDS forms when processing his variable annuity exchanges.⁹⁸ CK advised JM that they planned on having CKJ "repaper all of the accounts."⁹⁹ At that point, JM and CK called Respondent to participate in a three-way conference call.¹⁰⁰ JM informed Respondent that he would not award CKJ the sales contest prize until the accounts were repapered.¹⁰¹

On the same day, Respondent called his supervisor, PPC, then the current president of the Firm as well as CK's supervisor, and asked him if he was aware of the sales contest and the facts and circumstances of CKJ's internal review.¹⁰² PPC stated CK had already told him about the

⁹³ Tr. 500.

⁹⁴ Tr. 501, 879.

⁹⁵ Tr. 415-16, 500.

⁹⁶ Tr. 500-01.

⁹⁷ CX-236, at 9.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² Tr. 826.

situation.¹⁰³ Nonetheless, Respondent apprised PPC of CKJ's internal review and asked if PPC was comfortable with how the matter was being handled.¹⁰⁴ PPC stated that he was satisfied.¹⁰⁵

F. Implementation of Respondent's Recommendations

Thereafter, BB, CK, and CC began implementing Respondent's recommended course of action. CK and CC worked with CKJ to get the corrected EOI forms sent to his customers. Additionally, CKJ's assistant maintained a spreadsheet that tracked customers' responses.¹⁰⁶ CK kept Respondent and JM informed.¹⁰⁷ CC reviewed the corrected EOI forms, and then forwarded them to PRD.¹⁰⁸ Aside from the corrected surrender charge, which the customers acknowledged, CC detected other deficiencies with the corrected EOI forms.¹⁰⁹ CC informed CK of these deficiencies but did not convey them to Respondent.¹¹⁰ CC also made calls to CKJ's customers.¹¹¹ After completing the calls, he had concerns that the customers did not fully understand the variable annuities.¹¹² Again, CC informed CK but not Respondent, or anyone in the Compliance Department or PRD.¹¹³

On June 21, 2005, when 68% of the corrected EOI forms had been returned without any customer complaints, CK sent an email to Respondent, JM, and CC, stating "If [Respondent] agrees that this is an adequate sample, I believe [CKJ] won the Bragging Rights Campaign [sales

¹⁰³ Tr. 827.

¹⁰⁴ Tr. 877.

¹⁰⁵ Tr. 827.

¹⁰⁶ CX-206.1.

¹⁰⁷ CX-236, at 15; CX-192.

¹⁰⁸ Tr. 117, CX-224.2, at 53.

¹⁰⁹ Tr. 160-62.

¹¹⁰ Tr. 162. Respondent was not copied on any emails regarding deficiencies with the corrected EOI forms. Tr. 163; CX-199.

¹¹¹ Tr. 134.

¹¹² Tr. 138, 154.

¹¹³ Tr. 154-55.

contest].”¹¹⁴ When JM contacted Respondent regarding the status of CKJ’s internal review, Respondent updated JM and told him that he was comfortable with CKJ receiving the sales contest prize.¹¹⁵

III. DISCUSSION

The Complaint charges that Respondent violated NASD Conduct Rules 3010 and 2110 for failing to supervise registered representative CKJ in the sale of his variable annuity exchanges. There is no claim that Respondent violated any other FINRA rule, regulation, or law. For the reasons discussed below, the Hearing Panel found that Enforcement failed to prove by a preponderance of the evidence that Respondent failed to supervise CKJ.

During the Relevant Period, the NASD Conduct Rules made a clear distinction between a firm’s business-line supervisors and its compliance officer.¹¹⁶ Here, the parties agree that Respondent was not a business-line supervisor within THE FIRM’S supervisory structure. However, Enforcement urges the Hearing Panel to apply the standard set forth in *John H. Gutfreund*¹¹⁷ and deem Respondent a “supervisor” as a result of his involvement with CKJ’s variable annuity exchanges.

In *Gutfreund*, the chief legal officer informed three members of senior management that the submission of a false bid in an auction of U.S. Treasury securities by the head of the firm’s

¹¹⁴ CX-192, at 1.

¹¹⁵ Tr. 475-78.

¹¹⁶ Conduct Rule 3010(a)(2) required that a firm’s supervisory system designate registered principals “with authority to carry out the supervisory responsibilities of the member...” (emphasis added). On the other hand, NASD IM-3013 explained that “[t]he chief compliance officer is the primary *advisor* to the member on its overall compliance scheme and the particularized rules, policies and procedures that the member adopts.” (emphasis added). Notice to Members 04-71, which provides guidance on supervision and supervisory control, confirms the distinct roles of compliance and business line supervision.

¹¹⁷ *John H. Gutfreund*, 51 S.E.C. 93 (1992). *Gutfreund* was not a litigated case; the Securities and Exchange Commission (“SEC”) issued *Gutfreund* as a report of investigation (“Report”), pursuant to Section 21(a) of the Exchange Act. *Id.* at 93. In *Gutfreund*, the chief legal officer was the subject of the Report with respect to supervisory responsibilities of brokerage firm employees. *Id.* at 94. He consented to the issuance of the Report. *Id.*

Government Trading Desk was a criminal act, which should be reported to the government.¹¹⁸

Neither the chief legal officer nor the three executives investigated the misconduct or disciplined the trader for a number of months, during which the illegal activities continued.¹¹⁹ The SEC determined that the chief legal officer was a supervisor of the trader even though he was not formally designated as such.¹²⁰ *Gutfreund* provided the following test for determining how to define a supervisor:

Employees of brokerage firms who have legal or compliance responsibilities do not become “supervisors” ... solely because they occupy those positions. Rather, determining if a particular person is a “supervisor” depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of *responsibility, ability or authority* to affect the conduct of the employee whose behavior is at issue.¹²¹

In *Gutfreund*, the SEC considered the chief legal officer to be the trader's supervisor because he was informed of serious misconduct by “senior management in order to obtain his advice and guidance and to involve him as part of management's collective response to the problem,” and he shared responsibility to take appropriate action to respond to the misconduct.¹²² It emphasized that his role and influence within the firm, as well as the factual circumstances of the case, caused the chief legal officer to become a supervisor.¹²³ The SEC stated that “[i]t is not sufficient for one in such a position to be a mere bystander.”¹²⁴

¹¹⁸ *Id.* at 98-99.

¹¹⁹ *Id.* at 100-02.

¹²⁰ *Id.* at 113.

¹²¹ *Id.* (emphasis added).

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

At the outset, the Hearing Panel finds that the facts presented are distinguishable from *Gutfreund*. In *Gutfreund*, the chief legal officer had full knowledge of the misconduct, which was criminal. Here, BB and CK approached Respondent for his advice on a discreet issue: CKJ's failure to disclose the surrender charge on his variable annuity paperwork. It is clear that both BB and CK had a much fuller picture of the concerns regarding CKJ's exchanges.¹²⁵ Respondent was not intimately familiar with the EOI and SDS forms and did not see the forms at issue.¹²⁶ In contrast, BB reviewed CKJ's EOI and SDS forms and should have been fully aware of the true extent of the deficiencies. CC, as instructed by CK, also reviewed all of CKJ's transactions and reported the deficiencies to him. Further, when CC made customer calls, he believed that CKJ's customers did not understand the product, but this too was not conveyed to Respondent.¹²⁷ Despite their intimate knowledge of the facts, the evidence presented did not reflect that BB or CK conveyed the true extent of CKJ's misconduct to Respondent.

Further, unlike *Gutfreund*, Respondent was not a "bystander." He recommended a course of action in response to CKJ's failure to disclose the surrender charge and he continually received updates. Additionally, Respondent promptly informed both JM and PPC, the Firm's former and current presidents, of CKJ's disclosure issue and his proposed course of action.

The Hearing Panel finds that even applying the *Gutfreund* standard, the Respondent did not have the "responsibility, ability or authority" to affect CKJ's

¹²⁵ See CX-236, at 9; Tr. 246-48, 667, 669, 826-27, 877-78.

¹²⁶ Tr. 382-83, 390, 395, 402, 433, 878.

¹²⁷ Tr. 138, 154-55.

conduct and, thus, did not become his “supervisor.”¹²⁸ The Firm’s written supervisory procedures reveal that it employed a traditional supervisory structure, which clearly identified the Firm’s chain of supervision.¹²⁹ The procedures separated the Compliance Department from the management functions of the Firm and did not assign any supervisory responsibility to Respondent or his Compliance Department.¹³⁰ Further, no Firm manager or committee tasked Respondent with supervising CKJ, or reviewing or monitoring his variable annuity sales. In fact, Respondent had no interaction with CKJ during the Relevant Period.¹³¹

Moreover, Respondent had no authority or ability to control CKJ. He did not have the ability to hire, fire, or discipline CKJ or any management personnel at the Firm.¹³² Instead, throughout the internal review process, he had to rely on BB or CK to carry out any of his recommendations. Had they elected not to do so, Respondent would have had no recourse other

¹²⁸ Enforcement’s post-hearing brief identified other cases that have cited the *Gutfreund* standard when determining whether a legal or compliance officer may be deemed a “supervisor;” however, those cases are distinguishable from the instant case. See *Robert E. Strong*, 2008 SEC LEXIS 467, at *11 (Mar. 4, 2008) (sustaining sanctions against a compliance officer where the written supervisory procedures specifically assigned supervisory responsibility to that compliance officer for research reports and the approval of transactions in the accounts of research personnel); *George J. Kolar*, 55 S.E.C. 1009, 1012 (2002) (upholding sanctions against an area manager, not a compliance officer, who had supervisory authority for four branch offices and their registered representatives); *Kirk Montgomery*, 55 S.E.C. 485, 496-97 (2001) (denying respondent compliance officer’s claim for attorney’s fees and costs and noting that, although he was successful in the underlying litigation, the firm’s written supervisory procedures identified him as responsible for home office OSJ principal supervision); *Patricia Ann Bellows*, 1998 SEC LEXIS 1892, at *4 (Sept. 8, 1998) (refusing to overturn an administrative decision holding that compliance persons were not de facto insurers of proper behavior at broker-dealers, and therefore not liable as supervisors); *Conrad C. Lysiak*, 51 S.E.C. 841, 842-44 (1993) (finding that respondent compliance officer failed to supervise where firm’s Form BD listed him as supervisor of the branch office).

¹²⁹ RX-5, at 11-12.

¹³⁰ RX-5.

¹³¹ Tr. 786.

¹³² Tr. 492-94, 780-81, 847-48, 850; see *Arthur James Huff*, 50 S.E.C. 524, 532-33 (1991) (concurring opinion) (stating that the most probative factor indicating whether that person has the power to control the other’s conduct;” a “substantial part” of the power to control is evidenced by whether the individual has the ability “to hire or fire, and to reward or punish.”)

than contacting their supervisors.¹³³ In fact, BB testified that Respondent was not his supervisor; he did not report to Respondent; and Respondent provided only advisory services to him and the PRD.¹³⁴ Similarly, CK testified that he did not consider Respondent to be his supervisor and, while he would always tend to follow the advice of compliance officials, he took direction only from his supervisor, the president of the Firm, if he had an issue with the advice he received.¹³⁵

Enforcement argued that Respondent's involvement with CKJ's receipt of the sales contest prize demonstrated his ability to control CKJ. However, the Hearing Panel did not find that Respondent's involvement evidenced his ability to control CKJ. Initially, Respondent updated JM on the status of CKJ's internal review.¹³⁶ Then, with a majority of the corrected EOI forms submitted without customer complaints, Respondent told JM he had no objection to CKJ receiving the sales contest prize.¹³⁷ Thereafter, JM awarded CKJ the prize.

Enforcement also argued that because Respondent received draft and final audit reports that identified areas of improvement for PRD, he should not have relied on PRD. While Enforcement's argument has some merit, the Hearing Panel determined that, on balance, Respondent's reliance on PRD was reasonable under the circumstances. Here, the Audit Department conducted its variable annuity sales audit prior to Respondent's employment at the Firm.¹³⁸ Respondent received the draft and final audit reports, and

¹³³ Tr. 847-48.

¹³⁴ CX-224.1, at 35-36.

¹³⁵ Tr. 544-45, 666-67.

¹³⁶ Tr. 473-74.

¹³⁷ Tr. 475-78; CX-192.

¹³⁸ Tr. 354.

spoke to the Audit Manager during the preparation of the audit report.¹³⁹ Respondent met with the managers of each department, including BB, upon joining the Firm.¹⁴⁰ And, during the Relevant Period, he advised BB on various policies for PRD.¹⁴¹ Respondent testified that he understood that PRD's deficiencies related to recordkeeping as opposed to its ability to properly review variable annuity transactions.¹⁴²

Notably, the variable annuity sales audit reports were also provided to PRD's ultimate supervisor, the Firm's president, either JM or PPC during the Relevant Period.¹⁴³ PRD played a very important role at the Firm as it was responsible for reviewing all securities transactions, as well as all new account forms.¹⁴⁴ Respondent spoke to JM and PPC on a regular basis, and at no time did either individual ever tell Respondent that PRD could not perform its assigned function or that he needed to monitor PRD.¹⁴⁵ In fact, throughout the Relevant Period, no one at the Firm notified Respondent that PRD, which included BB, could not properly conduct suitability reviews.¹⁴⁶

The Hearing Panel finds that Respondent addressed the specific disclosure issue that BB and CK presented to him. That said, in rendering his advice, Respondent failed to appreciate the ramifications of a failure to disclose a surrender charge in the context of a variable annuity exchange suitability review. While Respondent testified that he

¹³⁹ Tr. 349-50, 356-57, 709-10, 715; CX-150, 155, 166.

¹⁴⁰ Tr. 786-88.

¹⁴¹ Tr. 359-62, 790, 856-57; RX-7.

¹⁴² Tr. 354-62.

¹⁴³ CX-150, 155, 166.

¹⁴⁴ Tr. 492; RX-5, at 16.

¹⁴⁵ Tr. 491, 788-89.

¹⁴⁶ Tr. 491-92, 789.

understood the concept of suitability as it applied to variable annuity exchanges,¹⁴⁷ he failed to focus on the fact that PRD had already conducted suitability reviews of a large quantity of CKJ's exchanges and approved them without the surrender charge. Because the exchanges involved a proprietary variable annuity product, PRD could not have accessed the surrender charge without CKJ's customers' assistance.¹⁴⁸ After careful consideration, the Hearing Panel finds that in this case Respondent's failure to expand the inquiry beyond what was presented to him does not establish him as CKJ's supervisor. Neither BB nor CK, or anyone else at the Firm, ever raised any suitability concerns to Respondent.¹⁴⁹ In fact, Respondent testified that he called BB and offered to review CKJ's transactions for suitability.¹⁵⁰ According to Respondent, BB declined his offer and specifically told him that there were no suitability issues with the transactions.¹⁵¹

To summarize, the Hearing Panel finds that Respondent's actions were limited to compliance-related activities. He provided advice to BB and CK in his role as a compliance officer and monitored their implementation of the recommended course of action. As such, the Hearing Panel finds that Respondent was not CKJ's supervisor.

¹⁴⁷ Tr. 447, 457, 463-64, 496.

¹⁴⁸ Tr. 105, CX-224.2, at 14-15. When questioned about this issue at the hearing, Respondent admitted that a reviewer could not determine the exact surrender charge for each exchange, but he stated that a reviewer could glean an approximate amount by looking at other similar variable annuity products. Tr. 874. Respondent testified that on May 19, 2005, when Respondent had a one on one conversation with BB, BB told him that he had reviewed all of CKJ's variable annuity transactions, calculated the surrender charges, and determined that they were suitable for the customers. Tr. 500, 875.

¹⁴⁹ Tr. 500, 873.

¹⁵⁰ Tr. 501, 879.

¹⁵¹ Tr. 415-16, 500. CK also testified that BB assured him that there were no suitability problems with the transactions. Tr. 592-94.

IV. CONCLUSION

The Hearing Panel finds that Enforcement failed to prove by a preponderance of the evidence that Respondent violated NASD Conduct Rules 3010 and 2110. The Complaint is therefore dismissed.

V. ORDER

For the reasons set forth above, the Hearing Panel dismisses the Complaint.¹⁵²

Maureen A. Delaney
Hearing Officer
For the Hearing Panel

¹⁵² The Hearing Panel has considered and rejects without discussion all other arguments of the parties.