FINANCIAL INDUSTRY REGULATORY AUTHORITY

OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. DAVID LERNER ASSOCIATES, INC. (CRD No. 5397) and WILLIAM MASON (CRD No. 1093049), Respondents.	Disciplinary Proceeding No. 20050007427 Hearing Officer – MAD **EXTENDED HEARING PANEL DECISION** April 4, 2012

Respondent David Lerner Associates, Inc. (DLA):

- **For willfully charging unfair municipal bond prices in violation of MSRB Rules G-30 and G-17, as described in the First Cause of Action, DLA is fined $1 million and required to pay restitution to the affected municipal bond customers, plus interest.**
- **For willfully failing to record the time of receipt on municipal bond customer order tickets, in violation of MSRB Rule G-8, as described in the Second Cause of Action, DLA is fined $25,000.**
- **For willfully failing to supervise municipal bond pricing and establish and maintain adequate procedures for municipal bonds, in violation of MSRB Rule G-27, as described in the Third Cause of Action, DLA is (1) fined $150,000, (2) required to revise its procedures to ensure that they are reasonably designed to comply with the requirements of MSRB Rules G-30 and G-8, including but not limited to the deficiencies found in this proceeding in connection with the excessive municipal bond markups, and (3) required to retain an independent consultant to review and approve DLA's revised procedures.**

- **For charging unfair CMO prices in violation of NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110, as described in the Fifth Cause of Action, DLA is fined $1 million and required to pay restitution to the affected CMO customers, plus interest.**
- **For failing to supervise CMO pricing and establish adequate procedures to monitor the fairness of prices for CMOs, in violation of NASD Conduct Rules 3010(a) and 2110, as described in the Sixth Cause of Action, DLA is (1) fined $150,000, (2) required to revise its procedures to ensure that they are reasonably designed to comply with the requirements of NASD Conduct Rule 2440 and IM-2440-1, including but not limited to the deficiencies found in this proceeding in connection with the excessive CMO markups, and (3) required to retain an independent consultant to review and approve DLA's revised procedures.**

Respondent William Mason:

- **For willfully charging unfair municipal bond prices in violation of MSRB Rules G-30 and G-17, as described in the First Cause of Action, Mason is fined $100,000 and suspended for 6 months from associating with any member firm in any capacity.**
- **For charging unfair CMO prices in violation of NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110, as described in the Fifth Cause of Action, Mason is fined $100,000 and suspended for 6 months from associating with any member firm in any capacity, which shall run concurrently with his suspension for the excessive municipal bond markups in the First Cause of Action.**
- **The Hearing Officer dissented as to the suspension imposed on Mason for the markup violations in the First and Fifth Causes of Action. The Hearing Officer would have suspended Mason from associating with any member firm in any capacity for 18 months.**

The Fourth Cause of Action charging Mason with supervisory violations relating to municipal bond pricing is dismissed. The Sixth Cause of Action charging supervisory violations relating to CMO pricing is dismissed solely with respect to Respondent Mason.

Respondents are also ordered to jointly and severally pay the costs of this proceeding.

Appearances

For the Complainant: Jeffrey Pariser and Matthew D. Meisner, FINRA, DEPARTMENT OF ENFORCEMENT, Washington, DC.

For Respondents David Lerner Associates, Inc. and William Mason: Paul J. Bazil and Anthony W. Djinis, PICKARD AND DJINIS, LLP, and Michael G. Shannon, THOMPSON HINE, LLP, Washington, DC.

Table of Contents

DECISION

I. INTRODUCTION

The Department of Enforcement ("Enforcement") brought this disciplinary proceeding against Respondents David Lerner Associates, Inc. ("DLA") and William Mason ("Mason"), the Head of DLA's Fixed Income Trading Department ("Trading Department"). The case concerns Respondents' retail sales of municipal bonds and collateralized mortgage obligation ("CMO") securities. Municipal bonds are debt securities issued by governmental entities such as cities, counties, or states to finance capital projects and fund day-to-day obligations. CMOs, a type of mortgage-backed security, are bonds that represent claims to specific cash flows from large pools of home mortgages. Enforcement alleges that the Respondents violated certain Municipal Securities Rulemaking Board ("MSRB") Rules, and NASD Conduct Rules and an Interpretive Memorandum, relating to the pricing of their municipal bond and CMO securities transactions. Enforcement also alleges violations relating to DLA's municipal bond customer order tickets and Respondents' supervisory systems and procedures.

II. BACKGROUND AND PROCEDURAL HISTORY

This disciplinary proceeding arose from Enforcement's investigation into concerns regarding DLA's markups on its retail sales of municipal bonds and CMOs that FINRA staff uncovered during DLA's 2005 examination. Ultimately, Enforcement's examination of Respondents' municipal bond sales encompassed the period from January 1, 2005, through January 31, 2007 (the "Municipal Bond Period"), and its examination of Respondents' CMO sales from January 1, 2005, through August 31, 2007 (the "CMO Period"). Enforcement concluded from its investigation that Respondents charged unfair

prices to their retail customers when selling municipal bonds and CMOs. Additionally, Enforcement concluded that DLA failed to record the time of receipt on numerous customer order tickets.

Enforcement filed a Complaint with the Office of Hearing Officers on May 7, 2010. Respondents filed an Answer and requested a hearing. Enforcement's Complaint contains six causes of action. In the First Cause of Action, Enforcement alleges that during the Municipal Bond Period, DLA and Mason willfully violated MSRB Rules G-30 and G-17 by charging customers unfair and unreasonable prices for municipal bonds. Enforcement alleges that, during the Municipal Bond Period, DLA acquired municipal bonds from other broker-dealers and brokers' brokers, which were purchased for DLA's inventory and then sold to DLA's customers either on the same day, or the next business day.[1] Enforcement alleges that DLA entered into more than 1,500 municipal bond transactions (the "Identified Municipal Bond Trades") in which it charged excessive markups that caused its customers to purchase the municipal bonds at prices that were not fair and reasonable, resulting in lower yields for the customers.[2] The charged municipal bond markups ranged from approximately 3.01% to 5.78%.[3]

In the Second Cause of Action, Enforcement alleges that DLA willfully violated MSRB Rule G-8 by failing to record the time of receipt on 2,307 customer municipal bond orders between April 13 and June 30, 2005.[4]

[1] Compl. ¶¶ 6, 14.

[2] Compl. ¶¶ 8, 12.

[3] Compl. ¶ 10.

[4] Compl. ¶ 21.

In the Third Cause of Action, Enforcement alleges that DLA willfully violated MSRB Rule G-27 by failing to supervise the conduct of its municipal bond activities and establish and maintain adequate procedures to (1) monitor the fairness of pricing for municipal bonds, and (2) ensure that it recorded the time at which its customers placed municipal bond orders.

In the Fourth Cause of Action, Enforcement alleges that Mason willfully violated MSRB Rule G-27 by failing to supervise the pricing of DLA's municipal bonds and establish and maintain adequate procedures to monitor the fairness of pricing for municipal bonds.

In the Fifth Cause of Action, Enforcement alleges that, during the CMO Period, DLA and Mason violated NASD Conduct Rule 2440 and IM-2440-1, and Conduct Rule 2110, by charging customers unfair and unreasonable prices for CMOs. Enforcement alleges that, during the CMO Period, DLA acquired CMO securities, primarily through its Florida branch office and then sold them to its customers within one business day.[5] Enforcement alleges that DLA entered into more than 1,700 CMO transactions (the "Identified CMO Trades") in which it charged excessive markups that caused its customers to purchase the CMOs at prices that were not fair and reasonable, resulting in lower yields for the customers.[6] The charged CMO markups ranged from approximately 4.02% to 12.81%.[7]

Lastly, Enforcement alleges in the Sixth Cause of Action that DLA and Mason violated NASD Conduct Rules 3010(a) and 2110 by failing to supervise the pricing of

[5] Compl. ¶¶ 33, 40.

[6] Compl. ¶¶ 35, 42.

[7] Compl. ¶ 37.

CMOs and establish adequate systems and procedures to monitor the fairness of prices for CMOs.

The Extended Hearing Panel ("Hearing Panel"), composed of two former members of FINRA's District 10 Committee and the Hearing Officer, conducted a hearing in New York, New York from June 6 through 16, 2011.[8] During the hearing, the Hearing Panel heard testimony from nine fact witnesses, including Mason; James Ruppert ("Ruppert"), FINRA Principal Investigator; John Hanlon ("Hanlon"), FINRA Case Manager; Albert Akerman ("Akerman"), DLA's Director of Compliance and Chief

[8] The hearing transcript is cited as "Tr." Enforcement's exhibits are cited as "CX-," Respondents' exhibits are cited as "RX-." The parties filed joint stipulations, which are cited as "Stip." At the request of the Hearing Panel, the parties filed joint exhibits after the hearing, which are cited as "JX-1" and "JX-2." When the parties prepared JX-1, relating to the relevant municipal bonds, Enforcement identified two additional DLA "buys" for New York State Environmental Facilities Corp on May 31, 2005, which are highlighted in JX-1 between lines 445 and 446. Given that the additional buy transactions were not originally included in Schedule A to the Complaint or CX-61, the Hearing Panel will disregard this transaction. Specifically, the Hearing Panel will disregard the DLA buy on May 31, 2005, and the 16 customer buys shown on lines 446-461. The Hearing Panel also disregards those particular transactions when citing to any CX or RX exhibits that correspond to the highlighted transactions in JX-1. Therefore, the relevant Identified Municipal Bond transactions are reduced from 1538 to 1522. The restitution amount will be reduced accordingly.

When the parties prepared JX-2, relating to the relevant CMO transactions, Respondents identified two additional DLA "buys" that they argue should have been included in Schedule B to the Complaint, which relate to Federal Home Loan Mortgage, highlighted in JX-2 immediately above line 1182, and Prime Mortgage Trust, highlighted in JX-2 immediately above line 1290. The Respondents were apprised of the relevant CMO specific buy transactions in Schedule B to the Complaint and CX-62. Respondents did not raise any issue with respect to the buys associated with Federal Home Loan Mortgage and Prime Mortgage Trust at any time pre-hearing or during the hearing. In the Hearing Officer's Order, dated May 26, 2011, she ordered Respondents to review CX-62 and identify any inaccuracies before the hearing. Respondents provided information to Enforcement that reduced the number of relevant CMOs from 1817 to 1746. Respondents did not identify any issues with the buys associated with Federal Home Loan Mortgage and Prime Mortgage Trust. In fact, Respondents offered RX-16 into evidence, which is identical to Schedule B of the Complaint except that it added line numbers, and RX-16 did not include the two additional purchases that Respondents now want included. Because Respondents have identified these two additional purchases after the hearing, the Hearing Panel is not able to question any of the witnesses about them. Further, Enforcement notes that a review of CX-40 reflects that the purchases that Respondents now want included did not result in customer purchases. Rather, the two additional purchases at issue were DLA purchases that were immediately sold to another broker-dealer. For all of the above reasons, the Hearing Panel will disregard the two additional purchases highlighted in JX-2, associated with Federal Home Loan Mortgage, immediately above line 1182, and Prime Mortgage Trust, immediately above line 1290.

The Identified Municipal Bond transactions are reflected in Schedule A of this decision, which was created from JX-1, CX-61, and CX-5. The Identified CMO transactions are reflected in Schedule B to this decision, which was created from JX-2, CX-62, and CX-6.

Compliance Officer ("CCO") during the Municipal Bond and CMO Periods; Anthony Meere ("Meere"), Branch Manager at DLA's headquarters; Joseph DeArce ("DeArce"), Executive Vice-President of Trading for DLA's Florida branch office; Mark Reilly ("Reilly"), registered representative with DLA's Trading Department; Steven Sormani ("Sormani"), DLA's CCO; and Alan Chodosh, ("Chodosh"), DLA's Chief Financial Officer. The parties also presented expert testimony.[9] Enforcement called James McKinney ("McKinney"), Donna Levin ("Levin"), and John Olvany ("Olvany"). Respondents called Charles C. Cox ("Cox") and Robert Lowry ("Lowry"). The parties filed post-hearing briefs and reply briefs with the Office of Hearing Officers on August 1 and August 19, 2011.

Based upon a preponderance of the evidence, the Hearing Panel makes the following findings of fact and conclusions of law.

[9] On December 2, 2010, the Hearing Officer granted the parties' joint motion to present expert testimony on certain agreed upon topics.

III. FINDINGS OF FACT[10]

A. Respondents

1. David Lerner Associates, Inc.

DLA has been a FINRA member since 1976. DLA is headquartered in Syosset, New York,[11] and employs approximately 350 registered representatives.[12] It operates a total of six offices: five in the New York tri-state area (New Jersey, New York, and Connecticut) and the sixth in Florida.[13] In the Syosset headquarters, the Trading Department is primarily a retail trading desk that focuses on the following products, with the corresponding volumes: municipal bonds (65%), CMOs (30%), and other securities (5%).[14] DLA's Florida branch office has a separate trading desk from the Trading Department.[15] It is responsible for its own inventory, and has its own profit and loss statement.[16] During the Municipal Bond Period, the Trading Department acquired the Identified Municipal Bonds from other broker-dealers and brokers' brokers. On the other hand, during the longer CMO Period, the Trading Department acquired CMO securities

[10] The facts contained herein are either undisputed or are the findings of the Hearing Panel based upon the credibility or believability of each witness. In making credibility determinations, the Hearing Panel considered all of the circumstances under which the witness testified, including: the relationship of the witness to the parties; the interest, if any, the witness has in the outcome of the proceeding; the witness's appearance, demeanor, and manner while testifying; the witness's apparent candor and fairness, or lack thereof; the reasonableness or unreasonableness of the witness's testimony; the opportunity of the witness to observe or acquire knowledge concerning the facts to which he or she testified; the extent to which the witness was contradicted or supported by other credible evidence; and whether such contradiction related to an important detail at issue. When necessary and appropriate, the Hearing Panel comments on the credibility of a witness or the weight given to a witness's testimony.

[11] Compl. ¶ 2; Answer at 2, 8, ¶ 2.

[12] Compl. ¶ 2; *see* Answer at 2.

[13] Compl. ¶ 2; Answer at 8, ¶ 2.

[14] Tr. 605.

[15] Tr. 618-19.

[16] Tr. 618-19, 621-23.

primarily through the Florida branch office,[17] which functioned as its dealer sales liaison. The Trading Department rarely transacted CMO business with any other CMO dealers.[18]

2. William Mason

Respondent Mason has been in the securities industry for approximately 28 years. He entered the securities industry in 1983, and joined DLA in November 1988. He is DLA's Executive Vice President of Trading and reports directly to DLA's president, David Lerner ("Lerner").[19] In addition to his registration as a General Securities Representative, Mason has been registered with FINRA as a Municipal Securities Principal since 1990, and a General Securities Principal since 1993.[20]

During the Municipal Bond and CMO Periods, Mason was (and currently is) the Head Trader of the Trading Department.[21] As Head Trader, Mason determined which municipal bonds and CMOs to purchase,[22] and was responsible for determining the retail pricing for all of the Identified Municipal Bond and CMO Trades.[23] He was ultimately responsible for the Trading Department's profit and loss,[24] and was compensated based on its profitability.[25]

[17] Tr. 611-13.

[18] Tr. 2271, 2603.

[19] Tr. 793; CX-7, at 20; RX-47, at 12; CX-8, at 11.

[20] Compl. ¶ 3; Answer at 8, ¶ 3; CX-10.

[21] Compl. ¶ 1; Answer at 8, ¶ 1.

[22] Tr. 606.

[23] Tr. 604-06, 609-10; CX-7, CX-8.

[24] Tr. 605.

[25] Tr. 627-28.

Since November 1992, Mason has also been DLA's designated supervisor for the Trading Department.[26] In that role, he supervised and directed DLA's purchases of the Identified Municipal Bonds and CMOs,[27] and was responsible for reviewing and approving the prices charged to retail customers for each of DLA's relevant retail sales prior to those sales being transacted.[28] Mason also supervised traders and was responsible for training them.[29]

B. Municipal Bonds

1. Available Municipal Bond Data

From January 1, 2005, through January 31, 2007, most of the Municipal Bond Period, the MSRB required brokers and dealers to report municipal bond trade data within 15 minutes of the execution of any trade.[30] The trade data was immediately posted and made available to the public free of charge on The Bond Market Association's website, www.investinginbonds.com,[31] allowing for complete market transparency.[32] Consequently, all market participants, including the Respondents, had access to the municipal bond prices charged by other dealers in all interdealer and customer transactions on a real-time basis.[33] During the Municipal Bond Period, municipal bond

[26] CX-7, CX-8.

[27] Tr. 604-11.

[28] Tr. 528-30, 567-68, 604-11.

[29] CX-7; Tr. 604, 610. David Lerner, the president of DLA, also relied on Mason to work with DLA's investment counselors; Mason would regularly address them at their weekly meetings. Tr. 2950.

[30] MSRB Notice 2005-09 (Jan. 31, 2005) at ¶ 1. MSRB required real-time trade reporting effective January 31, 2005. Prior to that time, trade data was available on a "day after the trade" or "T + 1" basis, which was standard during the first month of the Municipal Bond Period. *Id.* at ¶ 2.

[31] Stip. ¶ 3; MSRB Notice 2005-09 (Jan. 31, 2005), at 2.

[32] Tr. 273-74.

[33] CX-1, at 6.

dealers, like DLA, also could learn the prevailing markup practices of other industry participants through interactions with industry groups and regulators.[34]

2. Industry Pricing Practices

Enforcement presented James McKinney as an expert on, among other topics, municipal bond pricing and industry practices. McKinney, a Principal and Manager at FINRA member firm William Blair & Company ("William Blair"), has approximately 40 years of experience selling municipal bonds and supervising the sale of municipal bonds.[35] During the Municipal Bond Period, McKinney was responsible for supervising William Blair's municipal bond business as well as for setting the firm's policy on markups for its retail and institutional sales.[36] McKinney also participated in industry roundtables, attended dealer functions, read industry publications, and talked to other municipal bond dealers on a regular basis.[37] Further, he participated on the FINRA Fixed Income Committee where he directly interacted with the SEC specifically regarding markup policy.[38]

McKinney emphasized that the industry's municipal bond markups have significantly decreased in recent years as a result of new technologies in the market and the implementation of complete market transparency.[39] He explained that market participants understood that municipal bond markups had to be substantially less than

[34] *Id.*; Tr. 278-83.

[35] CX-1, at 21; Tr. 265-67.

[36] CX-1, at 3; Tr. 266-71.

[37] CX-1, at 6; Tr. 278-83.

[38] CX-1, at 6; Tr. 279-80.

[39] Tr. 273-74.

5%, and that markups greater than 3% would be subject to regulatory scrutiny.[40] This understanding was made clear at industry meetings and seminars.[41]

To illustrate the significant decrease in municipal bond markups in the industry, McKinney explained his firm's municipal bond markup policy. At William Blair, markups on retail municipal bond transactions generally ranged from 0.25% to 2.0%,[42] and averaged approximately 0.5% to 1.0% during the Municipal Bond Period.[43] Any trades with markups higher than 2% required McKinney's approval, which he gave only if extraordinary circumstances justified the 2% markup.[44] This policy applied to all retail municipal bond transactions, including small, odd-lot trades.[45]

3. Respondents' Purchases and Sales

As stated above, during the Municipal Bond Period, Respondents acquired the Identified Municipal Bonds from other broker-dealers and brokers' brokers.[46] Respondents generally purchased large blocks of municipal bonds into inventory, and then DLA's investment counselors sold the bonds on the same or next day in smaller

[40] CX-1, at 17; Tr. 278-83, 473, 478-79. McKinney stated that "what's really happening, what's really happening is half a point, three quarters of a point, 1 percent, it is all the way, way below anything near 3 percent." Tr. 479.

[41] Tr. 278-80. In Mason's Answer, he stated that "[t]hroughout his career, [he] has attended numerous continuing education programs, conferences, and panels organized by FINRA (and formerly NASD) for the subject of fair pricing and markups in the fixed income sphere." Answer at 4.

[42] CX-1, at 6; Tr. 270-71.

[43] CX-1, at 6; Tr. 271.

[44] CX-1, at 6; Tr. 270-72.

[45] Tr. 271.

[46] Tr. 668.

blocks to retail customers.[47] At the time of the sales, all the municipal bonds were investment grade and readily available.[48] The majority of the Identified Municipal Bonds were insured bonds.[49] DLA executed all of the Identified Municipal Bond trades on a principal basis.[50] DLA had minimal, if any, loss exposure, and never incurred a loss with respect to the Identified Municipal Bond transactions at issue.[51]

4. Respondents' Pricing and Markups

During the Municipal Bond Period, the municipal bond market was stable; the prices of the municipal bonds at issue did not change in any meaningful way between the time of DLA's purchases and its sales.[52] Mason set the prices, or was involved in setting the prices, that customers would pay to purchase those municipal bonds.[53] Mason testified that yield to the customer was the most important factor in determining municipal bond retail prices.[54] He also considered DLA's cost (i.e., its purchase price) when setting these prices.[55] When Mason purchased the municipal bonds, he used MSRB's publically

[47] CX-1, at 15-16; Tr. 605-06. DLA purchased the Identified Municipal Bonds listed in JX-1 as "DLA Buy" transactions on the "Transaction Date" and at the "Transaction Time" and for the price listed as "DLA Price" and the "Number of Bonds" indicated on JX-1 for each purchase. DLA sold to retail customers the bonds listed in JX-1 as "Cust Buy" transactions on the "Transaction Date" and at the "Transaction Time" and for the "Customer Price" and the "Number of Bonds" indicated on JX-1 for each customer purchase.

[48] Tr. 667, 2389-90, 2531-32.

[49] Tr. 334-35, 679.

[50] CX-1, at 15-16; Tr. 484-86, 605-06. The proximity of DLA's purchases and sales suggests that DLA purchased inventory in reaction to measured demand from its client base; therefore, these transactions were essentially riskless principal transactions. CX-1, at 15-16; Tr. 303-04.

[51] CX-1, at 16; Tr. 398-99.

[52] Tr. 304.

[53] Tr. 604-06.

[54] Tr. 661, 2413-14. The "Yield Percentage" listed in Exhibit CX-61 is the yield to the customer on the bond based on the customer price charged by Respondents, and as reported by DLA to the MSRB. Tr. 91.

[55] Tr. 673-75. Mason acknowledged that he represented in previous testimony that the first thing he would look at when setting municipal bond prices was contemporaneous cost. Tr. 695.

available data to ensure he was getting a good price.[56] However, he never utilized MSRB's data to learn (1) what other dealers charged their customers for the same bonds sold at the same time, (2) the yields received by other customers, or (3) the markups charged by other firms (by comparing customer sales prices with interdealer prices).[57] Additionally, in pricing municipal bonds for DLA's customers, Mason never attempted to determine the markups charged by other firms.[58]

At DLA, the municipal bond markups typically consisted of 3 points for the investment counselor's compensation, approximately 50% of which was shared with DLA, and an additional markup by the Trading Department.[59] DLA's markups on the Identified Municipal Bonds were not disclosed to customers.[60] Additionally, DLA did not disclose the firm's purchase price or the amount of the markups for the Identified Municipal Bonds to its investment counselors.[61]

a. *Calculation of the Markup*

McKinney stated that, absent countervailing evidence, a firm's contemporaneous cost is the best indication of the prevailing market price of a municipal bond.[62] He explained that the type of countervailing evidence that could justify using closer in time interdealer trades to determine prevailing market price would typically be limited to a

[56] Tr. 686.

[57] Tr. 671-73, 676-77, 686-87, 2853-59.

[58] Tr. 2853-59.

[59] Tr. 2673-76.

[60] Tr. 688, 848-49.

[61] Tr. 688. Respondents compare the Identified Municipal Bonds with mutual funds; however, mutual funds fully disclose the fees and costs through the prospectus. *See infra* footnotes 245 and 246 and accompanying text.

[62] CX-1, at 6. The appropriate methodology for calculating markup percentages on the municipal bond transactions is the price at which DLA sold the bonds to its customers minus DLA's Contemporaneous Cost, divided by DLA's Contemporaneous Cost. Tr. 302-04, 323-26; CX-1, at 15-16.

substantial block-size transaction, which could indicate that the market has changed;[63] closer in time odd lot transactions do not set prevailing market price.[64] Here, Respondents purchased the Identified Municipal Bonds either on the same day, or one business day before, the sales to the customers.[65] In order to confirm that the markets had not significantly moved in the short period between Respondents' purchases and their sales to customers, McKinney reviewed Respondents' trades and thousands of comparative trades in the same municipal bonds one day forward and one day back from the trade date "to get a feel for the trading climate surrounding each bond."[66] He never found any "demonstrable change in the market."[67]

Enforcement calculated the Identified Municipal Bond markups by using DLA's contemporaneous cost (the price at which Respondents purchased the municipal bonds).[68] Respondents' markups ranged from 3.01% to 5.78%, irrespective of the specific characteristics of the transactions.[69] McKinney analyzed the Identified Municipal Bond trades using the municipal bond industry's publically available pricing data.[70] He compared Respondents' trades to other trades in the municipal bond industry in the same

[63] Tr. 323-30.

[64] *Id.*

[65] *See generally* CX-61.

[66] CX-1, at 15.

[67] Tr. 304.

[68] CX-61, CX-1, at 16. DLA's markups on the sales of municipal bonds to customers identified in JX-1, calculated based on the difference between DLA's Contemporaneous Cost and the customer price, are listed in columns identified as "Markup Percentage" and "Markup in Dollars" in CX-61.

[69] CX-61, CX-1, at 12-13; Tr. 317-19. For example, DLA sold an odd lot of 10 bonds at a 3.37% markup on the same day it sold 100 of the same bonds at a 4.39% markup. *See* CX-61, at 15, lines 606-11. Additionally, it sold 20 bonds at a 3.46% markup on the same day it sold 190 of the same bonds at a 4.23% markup. *Id.* at 9, lines 325-30. Further, the relevant transactions did not fall into a dollar amount that could justify any extraordinary markups. Tr. 317-19.

[70] CX-1, at 4.

security at approximately the same time.[71] Based on his review of comparative trades in the industry, he concluded that nothing in the contemporaneous market conditions justified the markups charged by Respondents.[72] Respondents' municipal bond prices were inconsistent with industry practices during the Municipal Bond Period.[73] Specifically, Respondents' markups resulted in municipal bond prices that were consistently and significantly higher than the retail prices charged by other dealers for the same bonds.[74]

b. *Yield*

Based on McKinney's analysis, Respondents' municipal bond markups substantially reduced the yields received by their customers.[75] McKinney found that significant yield-stripping occurred in every trade because Respondents significantly overpriced their municipal bonds.[76] As a result of its municipal bond prices, DLA's retail customers consistently received municipal bond yields that were significantly lower in comparison to customers who held the same bonds at other firms.[77] Three examples of the Respondents' yield-stripping follow:[78]

---

[71] *Id.*

[72] *Id.* at 7.

[73] CX-1, at 19; Tr. 281-83, 477-79.

[74] CX-4, CX-1, at 16. Markups by other dealers on the same bonds were considerably less than Respondents' markups. Tr. 300, 453, 488-89. Reilly, a trader in the Trading Department, also testified about a pricing example in which DLA sold a new issue at approximately 4.25 points higher than any other firm's price. Tr. 2558-61.

[75] CX-1, at 16; Tr. 306-19.

[76] CX-1, at 16.

[77] CX-4; Tr. 98-103, 299-301.

[78] The Hearing Panel identified numerous examples exhibiting the same yield-stripping and excessive markups.

(1) DLA traded in a Bridgeport, Connecticut municipal bond, CUSIP 108151G9(6), initially offered to the public on March 30, 2006, with a 4.5% coupon[79] and an August 15, 2023 maturity date.[80] DLA purchased $150 million of this bond late in the afternoon of April 24, 2006, at a price of $99.75 to yield 4.52%.[81] On April 25, 2006, the day after its purchase, DLA sold the bonds to its customers at $104.00, with a markup of 4.26, which reduced the yield to 4.021%.[82] DLA's markup stripped more than 10% of the yield at the customer purchase price, reducing the yield by more than 48 basis points.[83] McKinney concluded that the markup should have been no more than 2.5%.[84]

(2) On March 28 and 29, 2005, DLA purchased blocks of Hartford, Connecticut General Obligation Bonds, CUSIP 4164144X8(8), at a price of $97.511, with a 4.57% coupon and an August 1, 2024, maturity date.[85] On March 29, 2005, Respondents sold these bonds to their customers at $101.625, a markup of 4.22%, which reduced the yield to the customer from 4.57% to 4.17%, or 40 basis points.[86] The markup stripped more than 9% of the yield at the purchase price.[87] McKinney concluded that the markup should have been no more than 2.5%.[88]

---

[79] A "coupon" signifies the annual rate of interest that the borrower promises to pay the bondholder, usually semi-annually in the case of municipal bonds and monthly in the case of CMOs. CX-49, at 108.

[80] CX-1, at 8-9 (Example 1); *see* CX-61, at 31, line 1277.

[81] CX-1, at 8.

[82] *Id.*; CX-61, at 31, lines 1277-80.

[83] CX-1, at 8-9.

[84] *Id.* at 9.

[85] *Id.* at 9 (Example 2); *see* CX-61, at 6, line 225.

[86] CX-1, at 9, CX-61, at 6, lines 225-26, 228-30.

[87] CX-1, at 9.

[88] *Id.*

(3) On July 6, 2006, DLA purchased Norwalk, Connecticut municipal bonds, CUSIP 6688435R(2), with a 4.50% coupon, maturing July 1, 2025, and a July 1, 2011 call date.[89] DLA's purchase price was $98.369, with a yield to the call of 4.87%.[90] Respondents marked the bonds up by 4.58% to $102.875, yielding 3.86% to the call.[91] The markup stripped more than 100 basis points from the yield to the call.[92] In fact, the bonds were called and were scheduled to be redeemed at $100 on July 1, 2011.[93] According to McKinney, the markup should not have exceeded 2.5%.[94]

c. *Expenses and Services*

DLA's expenses and services do not justify their Identified Municipal Bond markups. Respondents' presented no evidence that DLA's expenses were greater than the expenses incurred by other municipal bond or CMO dealers in the market.[95] Here, DLA's sales came from its own inventory, and there is no evidence that DLA incurred extraordinary expenses in executing or filling its customers' orders that could justify a higher markup.

There is also no evidence that the services provided by DLA to its municipal bond and CMO customers exceeded those provided by other municipal bond dealers in the

[89] *Id.* at 12; *see* CX-61, at 34, line 1405. A "callable bond" is subject to redemption prior to maturity at the option of the issuer on a specific date at a specific price. CX-49, at 108.

[90] CX-1, at 12; Tr. 312-14. "Yield to call" represents the return to a client on a bond based on existing call features, assuming that the bond will be called. CX-49, at 110.

[91] CX-1, at 12; Tr. 313; CX-61, at 34, lines 1410-14.

[92] CX-1, at 12; Tr. 314.

[93] CX-1, at 12; Tr. 313-14.

[94] CX-1, at 12; Tr. 314.

[95] Tr. 804-05. Mason testified that he factored DLA's expenses when pricing the municipal bonds; however, he never mentioned this factor in his Wells response. *Compare* Tr. 697 *with* CX-18.

market.[96] Here, the bonds were sold almost immediately by members of DLA's large sales force of investment counselors.[97] Respondents did not provide any extraordinary services that could warrant their high markups.[98]

d. *A Fair Markup*

McKinney analyzed every Identified Municipal Bond trade and calculated the *highest* fair markup for each municipal bond.[99] In doing so, he allowed for a "generous markup margin [that] still keeps DLA in the very high side of the markups experienced by other participants, on the same security at the same time."[100] Based on McKinney's determination of appropriate, fair markups, Respondents' total excess markups were $765,345.28 on the 1,522 Identified Municipal Bonds.[101]

C. CMOs

1. Industry Pricing Practices

Enforcement presented Donna Levin as one of its experts regarding CMO pricing and industry practices. Levin, a former Trader and Senior Vice-President at FINRA

[96] Tr. 802-04. The Hearing Panel did not find Mason's testimony regarding DLA's services to be credible. He had no recollection of mentioning services as a factor in his investigative testimony. Tr. 694, 745. In addition, although Mason generally claimed that he knew DLA provided a high level of service, he admitted that he was not aware of all of DLA's services or the services that other firms provided. Tr. 698-99.

[97] Respondents' Answer implied that the municipal bond and CMO sales were made on a "face-to-face" basis, but there is no evidence of any face-to-face communications concerning the customer purchases at issue in this case. Enforcement sought discovery on this issue, and the Hearing Officer ordered Respondents to produce any evidence of such face-to-face sales for the securities at issue. *See* Order Denying Respondents' Motion to Quash (Dec. 6, 2010), at 2. Respondents were directed to provide evidence of any such communications by January 10, 2011. *Id.* at 3. Respondents presented no evidence that the transactions at issue were made as a result of face-to-face meetings.

[98] Tr. 317.

[99] CX-1, at 23-26.

[100] CX-1, at 18. McKinney testified that, in considering Respondents' markups, he gave them "the benefit of doubt" that DLA performed a lot of customer counseling and incurred high expenses. CX-1, at 17; Tr. 317, 322-23.

[101] CX-5, at 45. The dollar amount and number of transactions provided in CX-5 were reduced to reflect the Hearing Panel's removal of 16 transactions. *See supra* footnote 8. Other than the 16 transactions referenced in footnote 8, the Hearing Panel accepts the calculations provided in CX-5.

member firm Ferris, Baker, Watts, Inc. ("Ferris Baker"), has approximately 20 years of experience pricing CMOs for sale to retail customers.[102] During the CMO Period, while Levin was employed with Ferris Baker, she was responsible for purchasing CMOs, determining the prices, setting the bids, deciding which bonds to offer, as well as educating the registered representatives.[103] Unlike the municipal bond market, the CMO market was not transparent.[104] However, to ensure that she priced CMOs fairly, Levin regularly obtained and reviewed CMO market information from a number of industry sources, including but not limited to: other traders, Bloomberg messages, dealer inventory screens, and Treasury yields.[105]

Levin considered several factors for her CMO pricing methodology: expected average life of the security,[106] yield, price, coupon, and yield spread compared to Treasury securities of similar maturity.[107] Levin emphasized that when pricing CMOs it is essential to be fair to the customer.[108] As she explained, because CMOs have prepayment risks, it is necessary for the customers "to be rewarded for the risk that they're taking with the uncertainty of the product."[109] Levin stressed that CMO markups must take into account

---

[102] CX-2, at 3; Tr. 1147.

[103] Tr. 1143-44.

[104] Tr. 729, 1764, 2614.

[105] Tr. 1144-50, 1173-75. Levin talked with other CMO traders on a daily basis either by phone or through Bloomberg messages. Tr. 1144-45. She reviewed dealer inventories on a dealer-by-dealer basis. Tr. 1174.

[106] Unlike municipal bonds, CMOs do not necessarily mature on a fixed date. Rather, the underlying borrower is a homeowner whose monthly mortgage payments typically include principal, which is paid to the CMO holder over time. CMOs are subject to significant prepayment risk because a homeowner may choose to accelerate principal payments or to refinance the mortgage and pay off the entire principal. Both of these scenarios are especially likely to occur in a declining interest rate environment. *See* CX-3, at 5-7 ¶¶ 7-8.

[107] CX-2, at 3-4, 25.

[108] Tr. 1174.

[109] Tr. 1151.

average life.[110] She charged lower markups on shorter average life CMOs because markups have a greater impact on the overall yield of fixed income instruments (like CMOs) with shorter durations.[111] To prevent this adverse impact on the yield, Levin utilized a "sliding scale" approach to calculate CMO markups, adding less of a markup (in the form of sales credit) for shorter average life CMOs, and more of a markup for longer average life CMOs.[112] In pricing CMOs, Levin typically took a quarter of a point for her trading desk, and then applied a sales credit of *up to* 3 points.[113] The 3 point sales credit would be added only to the CMOs with the longest average lives; shorter average life CMOs would get less sales credit based on Levin's sliding scale.[114]

During the CMO Period, Levin charged markups on CMOs of less than 4% "in order to be fair to … customers."[115] As she explained, very high markups significantly reduce customer yield.[116] Because of the relatively wide spread between the bid and offer side, it would be difficult for a customer to recover a high markup if a particular CMO needed to be sold.[117] Further, Levin noted that the high markups prevent customers from investing more principal in CMOs or other fixed income products.[118]

---

[110] Tr. 1151-56.

[111] CX-2 at 5; Tr. 1151-56; *see* CX-3, at 23; Tr. 1048-51 (markups have greater impact on yield of CMOs with shorter average lives).

[112] Tr. 1151-56.

[113] Tr. 1151-53.

[114] Tr. 1151-52.

[115] CX-2, at 6; Tr. 1154-55. Levin's Report noted "a few exceptions to this practice," but none of the noted exceptions was applicable to the Identified CMOs. CX-2, at 6.

[116] Tr. 1155-58.

[117] CX-2, at 6.

[118] *Id.*

2. Respondents' Purchases and Sales

During the CMO Period, Respondents purchased close to 100% of the Identified CMOs from DLA's Florida branch office.[119] When selling CMOs out of its inventory, the Florida branch office charged DLA's Trading Department the same price that it charged other dealers.[120] When the Trading Department requested CMOs that were not in inventory, it paid the Florida branch office a 0.25% commission for the CMOs.[121] Respondents purchased the CMOs from the Florida branch office in large blocks for DLA's inventory, and then DLA's investment counselors sold them either the same day or next day in smaller blocks to customers.[122] DLA executed all of the Identified CMO trades on a principal basis.[123]

Each of the Identified CMOs had unique, customized features.[124] At the time of DLA's sales, all of the Identified CMOs were investment grade and readily available.[125] Because the Identified CMOs were rated AAA[126] during the relevant period, the most

[119] Tr. 611-13. During the CMO Period, DLA purchased the CMOs indicated in JX-2 under the "DLA Purchase Information" columns on the "DLA Purchase Date" for the "DLA Purchase Price" and in the "DLA Purchase Quantity" listed in JX-2.

[120] Tr. 1938-39, 2253, 2604.

[121] Tr. 623, 2253-54, 2604-07.

[122] Tr. 606, 609-10, 616-17; CX-62; JX-2. DLA sold to retail customers the CMOs indicated in JX-2 on the "DLA Sale Date to Customer" for the "DLA Sales Price to Customer" and in the "DLA Sale Quantity" listed in JX-2. The Yield to Average Life Percentage, provided by DLA and set forth in CX-62, reflects the yield, based on the average life information available at the time, as of the time of the customer purchase. Tr. 894.

[123] Tr. 606, 609-10.

[124] Tr. 2028-34.

[125] CX-2, at 24; CX-3, at 9; Tr. 719, 726, 1060-61, 1181-82, 2231-33, 2601.

[126] AAA is the highest rating assigned by Moody's and S&P, credit rating agencies, which indicates that the capacity to pay interest and repay principal is extremely strong. CX-49, at 8.

significant risk was prepayment risk.[127] More than half of the Identified CMOs were support bonds,[128] a class of CMOs that are the most volatile with respect to prepayment risk.[129]

3. Respondents' Pricing and Markups

During the CMO Period, the CMO market was stable; there was no evidence of market turbulence impacting interest rates or credit quality of the CMOs at issue between the time of DLA's purchase and sale of such CMOs.[130] Although Reilly, another trader in the Trading Department, assisted Mason in pricing the Identified CMOs, Mason was responsible for determining the retail pricing of all CMOs.[131] Mason testified that yield to the customer was the most important factor in determining the CMO retail prices.[132] The Trading Department's contemporaneous cost was the starting point for CMO retail pricing.[133] Mason based the CMO prices on the spread between the Treasury yield curve

[127] CX-3, at 6; Tr. 1011-14, 2267. Prepayment risk relates to the uncertainty regarding the timing of principal and interest payments, because homeowners may prepay some principal during the life of a loan, or refinance the entire loan, making the timing of principal payments in CMOs uncertain. CX-3, at 6; Tr. 1011-14, 2267. The prepayment risk of CMOs is particularly significant during periods of declining interest rates because homeowners frequently refinance their mortgages as interest rates go down. Reductions in interest rates also make it difficult for these investors to find opportunities to reinvest the principal from the prepayments in comparable securities at comparable yields. CX-3, at 6-7; Tr. 1014. Mason acknowledged that CMOs have prepayment risk. Tr. 722-23.

[128] CX-3, at 9.

[129] *Id.* at 8-9; Tr. 720, 1016-17; CX-49, at 110.

[130] CX-3, at 11-12; Tr. 1025. Respondents claimed that the CMO market was not stable during this period because yields on 10-year and 20-year Treasury bonds increased by more than 100 basis points in the course of a calendar year. Tr. 2292-94. However, the pertinent question is whether the market was stable when the CMOs were bought and sold, the relevant two-business-day periods at issue (i.e., were there changes in the market such that it would not be appropriate to calculate markups based on Respondents' contemporaneous cost). Respondents did not present evidence of such intra-day volatility.

[131] Tr. 604-05, 609-10. In pricing CMOs, Mason could only consider information that was available to him at the time of his pricing. Tr. 778.

[132] Tr. 727, 2277, 2611-12.

[133] Tr. 2609.

and the yield on the CMO being priced.[134] Mason determined the average life of a CMO by using a tool on the Bloomberg system, and then compared the yield on the CMO with a Treasury bond of a comparable life.[135] Respondents priced CMOs for retail regardless of whether the CMOs were sourced from DLA's Florida branch office or from another broker-dealer.[136]

At DLA, the CMO markups typically consisted of: (1) a quarter point or other initial markup added by the Florida branch office, (2) 3 points for the investment counselors representing sales credit (approximately 50% of which went to the firm), and (3) an additional markup by the Trading Department.[137] As a result, DLA customers sometimes experienced as much as a 9.5% markup on CMOs.[138] DLA's Florida branch office never disclosed its purchase price to the Trading Department when selling CMOs out of inventory.[139] Accordingly, Respondents did not consider the additional markup charged by the Florida branch office when setting retail CMO prices.[140]

[134] Tr. 726-27, 738. CMO yields are often quoted in relation to yields above Treasury securities with maturities closest to the estimated average life for the underlying mortgages. CX-3, at 7; Tr. 1015-16, 2279-80, 2611. This relationship is referred to by market participants as "yield spread." CX-3, at 7; Tr. 1015-16. Investors in CMOs should receive yields that are well above the yields of comparable Treasury securities to compensate them for prepayment risk due to CMOs' uncertain average lives. CX-3, at 7; Tr. 2279-80.

[135] Tr. 738-43. CMOs have a higher yield than Treasury bonds. Tr. 720-21.

[136] Tr. 2609-10.

[137] Tr. 623, 2618, 2915-20. DLA always added 3 points of sales credit. Tr. 2915-20.

[138] The Florida branch office sometimes marked up its bonds up as much as 4 points over its acquisition price before selling to the Trading Department, which, when combined with the Trading Department's additional markups, resulted in markups to DLA customers of as much as 9.5%. Tr. 2384-88, 2622-33.

[139] Tr. 2621-22.

[140] Tr. 2631-32.

DLA's markups on the Identified CMO sales were not disclosed to its customers.[141] Further, DLA did not disclose the firm's purchase price or the amount of the markups for the Identified CMOs to its investment counselors.[142]

a. *Calculation of the Markup*

Enforcement calculated the markups for the Identified CMOs by using DLA's contemporaneous cost (DLA's purchase price for the CMOs).[143] Enforcement used the cost at which the CMOs were acquired by DLA's Florida branch office as the cost basis rather than the price the Trading Department paid to acquire the CMOs from the Florida branch office.[144] The markups on the CMO transactions at issue ranged from 4.02% to 12.39%.[145] The median markup for the CMO transactions at issue was approximately 4.9%.[146]

Levin analyzed Respondents' CMO trades on a trade-by-trade basis.[147] Her analysis involved reviewing each CMO with the available information on Bloomberg (136 CUSIPs) and calculating the expected average life at the time of purchase based on

[141] Tr. 688, 2618. Respondents compare the Identified CMOs with mutual funds; however, mutual funds fully disclose the fees and costs through the prospectus. *See infra* footnote 291 and accompanying text.

[142] Tr. 746.

[143] CX-62. DLA's markups on the sales of CMOs identified in JX-2, calculated based on the difference between "DLA Purchase Price" and "DLA Sale Price to Customer," are listed in columns identified as "Markup Percentage" and "Markup in Dollars" in CX-62. Both Levin and Olvany, Enforcement's CMO experts, concluded that contemporaneous cost was the proper measure for calculating the markups on the Identified CMOs. Tr. 1183-87; CX-3, at 11-12.

[144] Tr. 1386-87. The Hearing Panel finds that it is proper to calculate DLA's contemporaneous cost using the Florida branch office's purchase price. Measuring the markup using the Trading Department's purchase price from DLA's Florida branch office would not represent the firm's actual cost. Further, such a practice would enable firms, such as DLA, to falsely make their markups appear lower by buying and selling CMOs through various branch offices and thereby increasing their "cost," which would result in a lower markup.

[145] CX-62. The upper limit of the markup range is lower than the upper limit described in the Complaint because certain transactions were removed prior to the hearing. *See supra* footnote 8.

[146] CX-3, at 15.

[147] Levin's report provides a detailed analysis of 35 of Respondents' trades, which she selected to constitute a cross section of Respondents' CMO trades, choosing "examples that showed a variety of yields, markups, and average lives." CX-2, at 10-23.

information provided by Respondents.[148] Based on that average life, Levin applied her sliding scale pricing methodology to determine the CMO price.[149] For example, Levin considered Respondents' trades of CUSIP 94982WAV6 on March 15, 2006.[150] Respondents purchased the CMO for $90, and sold it on the same day with a 6.39% markup and a price of $95.75, resulting in a yield of 5.84% at an average life of 9.86 years.[151] Levin determined that $92.25, which includes a 2.78% markup, would be a fair price for this CMO, resulting in a yield of 6.34% at the average life.[152] Levin stated that Respondents' markups on this CMO were "especially high," particularly "for a shorter average life CMO."[153] In each instance, Respondents' trades were at prices higher than Levin would have charged; specifically, Respondents' markups were between 19.02% and 222.64% higher than Levin's.[154] Levin found that Respondents' customers received "a lower return and less interest income over the life of the investment than they would have received if the markups had been more fair across-the-board."[155] Levin concluded that Respondents' charged excessive markups, resulting in unfair prices for its customers.[156]

---

[148] CX-2, at 8-10.

[149] CX-2, at 8-10, 30-35. Levin confirmed her methodology by checking it against actual trade data from Ferris Baker. CX-2, at 5. That data, although limited, was consistent with the methodology she applied in her analysis of Respondents' trades. *Id*.

[150] *Id.* at 12-13 (discussing Example 6).

[151] *Id.* at 12; *see* CX-62, at 9, line 412 (Respondents' sale of CMO on Mar. 15, 2006). Respondents also sold the CMO on the same day at $95.25, and then on the next day for $95.75 and $95.875. CX-62, at 9, lines 413-15. All of these prices were well over Levin's highest fair markup.

[152] CX-2, at 12.

[153] *Id.* at 13. Nine of the 35 trades analyzed by Levin contained similar markups. *Id*. at 10-23.

[154] *Id.* at 24.

[155] *Id.* at 23.

[156] Tr. 1191.

b. *Yield*

Enforcement also presented expert testimony on CMOs from John Olvany. The Hearing Panel accepted Olvany's analysis and conclusions over that of Respondents' experts for the reasons discussed below.

Olvany spent more than two decades working in global fixed income markets, including trading products such as CMOs. During the CMO Period, Olvany was a Managing Director and Senior Manager of the Institutional Sales and Trading Group for the Chicago Office at Morgan Stanley.[157]

Olvany conducted yield spread analyses, demonstrating that Respondents' markups in the Identified CMOs were unfair.[158] First, he conducted a yield spread analysis in which he compared the difference in the yield spread obtained by DLA at the market price (i.e., what DLA paid for the CMO) and the yield spread obtained by Respondents' customers at the price DLA charged for the CMO.[159] Based on his analysis, Olvany determined that DLA's markups reduced customers' yield spreads by approximately 17.3% to 62.89% from the prevailing market price.[160]

Second, Olvany conducted a yield spread analysis that focused on the yield spreads on support bond CMOs, which have widely variable average lives and therefore

[157] CX-3, at 3, 32-35.

[158] Olvany analyzed the 185 CMO CUSIPs at issue to develop an appropriate cross-section to sample. He selected a sample of 28 CUSIPs, including both agency and non-agency CMOs, different types of CMOs (support bonds and sequential pay bonds), and bonds with the lowest and greatest markups. CX-3, at 4-5 ¶ 6 and App. 3. Olvany then conducted a detailed review of the trades in the 28-CUSIP sample, which captured 1,014 of the total 1,817 CMO trades originally at issue. *Id.* at 4-5 ¶ 6.

[159] *Id.* at 26 ¶ 34 and App. 6. Investors in CMOs "are only compensated for the incremental risk of these securities relative to U.S. Treasury securities by the yield spread;" yield spread is so important that CMOs are "often quoted in relation to yields above Treasury securities with maturity closest to the CMO's estimated average life for the underlying mortgage loans." CX-3, at 7 ¶ 10, 26 ¶ 34.

[160] *Id.* at 26 ¶ 34 and App. 6; Tr. 1057-59.

greater prepayment risk than the other types of CMOs sold by Respondents.[161] Olvany compared the yield spreads on support tranches of CMOs to the yield spreads for BBB corporate bonds during the relevant period because, in his experience, investors view those as comparable securities when "analyzing differences in yield spreads for alternatives to US Treasury securities."[162] Olvany's analysis revealed that in more than 92% of the support bonds analyzed, DLA's markups reduced its customers' yield spreads to well below the BBB corporate yield spread.[163]

Olvany concluded that "[w]ith reduction in yields of this magnitude, the customers of DLA paid unfair prices due to markups which reduced the merits of these investments."[164] In sum, the yield spreads showed that Respondents charged their customers "prices that were not fair and reasonable to purchase CMOs in the Relevant Period."[165]

c. *Expenses and Services*

Respondents' expenses and services do not explain their CMO prices. Respondents presented no evidence that they incurred extraordinary costs in connection with the sales of the CMOs.[166] They obtained widely-available, investment-grade CMOs,[167] and immediately sold them to their customer base. Olvany noted that he did not uncover anything to indicate that Respondents' costs of acquiring CMOs "were excessive

[161] CX-3, at 8-9 ¶ 14.

[162] *Id.* at 27-28 ¶ 37.

[163] *Id.* at 29 ¶ 40.

[164] *Id.* at 26 ¶ 34. Mason stated that the yield spread for the Identified CMOs when compared to a Treasury security would have been 80 to 100 basis points. Tr. 2958-60.

[165] CX-3, at 10 ¶ 18.

[166] Meere, the branch manager for the Syosset headquarters, could not compare DLA's expenses to other firms' expenses. Tr. 804.

[167] Answer at ¶ 39 (CMOs were investment grade); Tr. 719.

or extraordinary in the Relevant Period."[168] Regarding services, as with their municipal bond sales, Respondents presented no evidence that their services warranted their high markups.

d. *Pattern*

Both Levin and Olvany concluded that Respondents engaged in a consistent pattern of high markups (above 4%) that significantly reduced the yield DLA's customers obtained.[169] Respondents did not differentiate between shorter and longer average life CMOs when setting markups, but rather marked up almost all of the CMOs in a similar manner.[170] Respondents' markups were mostly in the 4.0% to 6.0% range, regardless of the average life.[171] More than a quarter of the trades had markups between 4.85% and 5.05%, with virtually no variation based on average life.[172]

Respondents' failure to consider average life in their pricing was particularly unfair to customers who purchased CMOs with shorter average lives because, as discussed above, markups have a greater impact on shorter duration fixed income securities. Similarly, Respondents' CMO prices did not vary in relation to the size of the transaction.[173] Whether a DLA customer bought as much as $225,000 or as little as $8,000 of a CMO, the price was marked up "without consideration for the amount of

[168] CX-3, at 26.

[169] CX-2, at 23; Tr. 1178-80; CX-3, at 26; Tr. 1057-60. Hanlon also detected a pattern with Respondents' CMO markups. Tr. 880. Further, independent of any expert or fact witness testimony, the Hearing Panel observed a pattern with Respondents' CMO markups.

[170] CX-3, at 17; CX-2, at 23; Tr. 1033-37, 1048-51, 1162-63, 1304-08, 2612-14.

[171] CX-62; CX-3, at 17; CX-2, at 23; Tr. 1033-37, 1048-51, 1162-63, 1308.

[172] CX-3, at 17 ¶ 27 and Ex. C and C-1; *see id.* at 12-13 ¶¶ 22-23 and Ex. A-1.

[173] CX-3, at 24-25 ¶ 32 and Ex. H.

money involved in the transaction."[174] DLA's markups were primarily in the 4.0% to 6.0% range regardless of the total dollar amount of the transactions.[175]

e. *A Fair Markup*

Levin determined the *highest* fair markup that Respondents could have charged by analyzing the Identified CMOs using her sliding scale methodology.[176] In doing so, she acknowledged that every trading desk is slightly different.[177] Accordingly, Levin was generous and flexible in her analysis, utilizing a greater markup for each Identified CMO than she would have charged.[178] She gave Respondents "the benefit of the doubt" while still ensuring that the price was fair to the customer.[179] Using Levin's determination of appropriate, fair markups, Enforcement calculated that Respondents' total excess markups were $692,731.24 on the 1746 Identified CMOs.[180]

D. Time of Receipt on Customer Municipal Bond Orders

MSRB Rule G-8(a)(vii) requires firms to record the date and time of receipt for all municipal bond customer orders. DLA's order processing system did not record the *time of receipt* for customer municipal bond orders. While DLA's investment counselors completed order tickets when a customer purchased a municipal bond,[181] the tickets did *not* include the time of the customer's order.[182] Once the investment counselor completed

[174] *Id.* at 24 ¶ 32.

[175] CX-3, at 24; Tr. 1059-60.

[176] CX-2, at 10.

[177] Tr. 1177.

[178] Tr. 1176-78.

[179] *Id.*; CX-2, at 10, 31-35.

[180] CX-6.

[181] Tr. 511.

[182] CX-12; Tr. 511-12, 812.

the order ticket, he delivered the ticket to the Trading Department for execution;[183] however, the Trading Department did not stamp the tickets either.[184] After execution of the order, the Trading Department sent the order tickets to the Operations Department for processing.[185] The Operations Department time-stamped the order tickets;[186] but, at times, DLA did not process (and therefore did not time-stamp) municipal bond order tickets on the same day that it received orders from its customers.[187] Accordingly, the time-stamp on DLA's customer municipal bond order tickets did not accurately record the time of receipt of the customer order.

In 2,307 instances between April 13 and June 30, 2005, DLA did not record the time at which the firm received customer municipal bond orders.[188]

E. Supervision and Written Supervisory Procedures

1. Municipal Bond and CMO Pricing

DLA's written supervisory procedures ("WSPs") did not provide adequate guidance for Respondents' municipal bond and CMO pricing. Additionally, there is no evidence that Mason established or maintained any additional procedures for reviewing DLA's retail prices for municipal bonds or CMOs. Prior to May 3, 2005, DLA's WSPs did not specify that the firm must charge fair prices for its municipal securities.[189] Prior to the revisions in April 2006, DLA's WSPs provided only that municipal securities and

[183] Tr. 512. Trades originating in the Syosset office were physically delivered to the Trading Department. Tr. 513. Trades originating from one of DLA's branch offices were faxed to the Trading Department; however, the fax times did not reflect the time of the customer order. Tr. 246-49, 512-13.

[184] Tr. 785-86.

[185] Tr. 151-56, 513-14, 599-600, 811-12.

[186] Tr. 514.

[187] Tr. 515-17, 786-87.

[188] Tr. 510-15, 811-12; CX-12.

[189] *Compare* CX-7, at 14 *with* RX-47, at 265-266; Tr. 519-20.

other transactions needed to be approved by a Branch Manager or the Trading Department.[190] The WSPs did not require the Branch Manager or Trading Department to review the transactions (except for swaps); nothing in the WSPs required a review to ensure that the securities were fairly priced.[191]

DLA modified its WSPs effective April 26, 2006. The revised procedures limited the Branch Manager's approval requirement to trades of more than $1 million in municipal bonds.[192] While the WSPs required a review of municipal bond markups based on the factors set forth in MSRB Rule G-30,[193] the procedures mistakenly relied on the same factors used to review CMO markups.[194] The WSPs also provided for Mason, the Trading Department's "designated supervisor," to review his own markups.[195]

Mason was not the only person required to review municipal bond and CMO transactions during the Municipal Bond and CMO Periods; the Compliance Department had a supervisory role as well.[196] The Compliance Department only supervised the pricing of retail municipal bonds and CMOs through periodic spot checks conducted by either the CCO or another member of the Compliance Department;[197] it did not generate any surveillance reports relating to the prices Respondents set for municipal bonds and CMOs.[198] The spot checks reviewed only trades where the markups exceeded 5% of the

---

[190] CX-7, at 14.

[191] *Id*.

[192] CX-8, at 150.

[193] *Id*. at 266-67.

[194] *Id*. at 281; Tr. 530-31. Among other things, IM-2440-1 provides for review of the pattern of markups; MSRB Rule G-30 does not.

[195] RX-47, at 265; CX-8, at 266-67; Tr. 528-30, 535-36.

[196] Tr. 538-45.

[197] Tr. 541-47, 553.

[198] Tr. 542-43.

prices reflected in market data.[199] Akerman, the Director of Compliance and later the CCO during the CMO Period, was responsible for the spot checks; however, he was not aware of the applicable market price for purposes of the CMO spot checks.[200]

DLA's spot checks did not result in any changes to the Respondents' pricing or markup practices with respect to municipal bonds or CMOs.[201] Akerman could not recall ever advising Mason that a customer purchase price he had set was too high or requiring him to provide a refund to any customer.[202] Further, at no time did Akerman observe any patterns with respect to Respondents' municipal bond and CMO pricing.[203]

Other than the Compliance Department's spot checks, Mason provided the only supervision of the municipal bond and CMO pricing. However, DLA did not provide Mason with any formal training on setting municipal bond and CMO prices.[204] Mason could not recall receiving any case law or guidance on setting retail prices or markups from the Compliance Department,[205] and he never approached the Compliance Department to confirm that he was properly and fairly pricing municipal bonds and CMOs.[206] Moreover, there was no evidence that Lerner, Mason's supervisor, provided any guidance or oversight.

---

[199] Tr. 545-50.

[200] Tr. 508-09, 545, 553-66.

[201] Tr. 550-52, 566-68.

[202] Tr. 550-52, 566-67.

[203] Tr. 552, 567.

[204] Tr. 639-40, 2963-64.

[205] Tr. 642-47.

[206] Tr. 2945.

2. Municipal Bond Order Tickets

DLA's WSPs, effective between April and June 2005, did not require the firm to record the time of customer orders.[207] DLA had no additional procedures or supervisory systems in place to ensure that the firm recorded the time at which customers placed municipal bond orders. As discussed above, DLA's actual process for handling municipal bonds did not result in order times ever being recorded.

IV. CONCLUSIONS OF LAW

A. Municipal Bond Markups

1. Legal Standard

MSRB Rule G-30 requires Respondents to sell municipal bonds to customers at prices that are "fair and reasonable."[208] The Rule provides the following relevant factors to be considered when pricing municipal bonds:

- the fair market value of the securities at the time of the transaction, in the best judgment of the broker;
- the expense involved in effecting the transaction;
- the fact that the broker is entitled to a profit; and
- the total dollar amount of the transaction.[209]

The MSRB also issued interpretive notices setting forth additional factors that may be relevant, including:

[207] CX-7, at 14-15; *cf.* RX-47, at 159; Tr. 520-21. As noted, DLA's revised WSPs, effective April 26, 2006, required "the [T]rading [D]epartment to maintain a record of orders in municipal securities consistent with the requirements of MSRB Rule G-8." CX-8, at 266 (Section 16.6.4). However, this change did not correct the problem. The Trading Department could not have placed an accurate time-stamp showing the time of the customer order because the investment counselors did not deliver the trading ticket to the Trading Department until well after the order was placed. The modified WSPs failed to take this into account. In fact, FINRA cited DLA on this issue as recently as January 29, 2010 (for conduct through June 30, 2008). CX-52.

[208] MSRB Rule G-30.

[209] *Id.*

- the availability of the security in the market;
- the price or yield of the security;
- the maturity of the security; and
- the nature of the professional's business.[210]

The MSRB has advised that in determining whether a municipal bond has been fairly and reasonably priced, the "most important" factor to be considered is "the resulting yield to a customer."[211]

MSRB Rule G-17 requires a dealer to deal fairly with customers and not to engage in deceptive, or unfair practices.[212] "Inherent in this responsibility is that dealers charge fair prices in transactions with their customers."[213]

2. Prevailing Market Price

The "key issue" in a markup case is determining the "prevailing market price" for the securities at issue.[214] It is with reference to this price that the dealer must determine the appropriate markup. "[I]n the absence of countervailing evidence, a dealer's contemporaneous cost [of acquiring the security] is the best evidence of current market."[215] This standard "reflects the fact that prices paid for a security by a dealer in

[210] MSRB Interpretations of Rule G-30, Report on Pricing (Sept. 26, 1980) (available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx?tab=2) (hereinafter "MSRB Report on Pricing") (citing prior notices dated September 20, 1977 and October 28, 1978). MSRB has stated that "[a]s a general matter, the NASD's rules of fair practices do not apply to municipal securities transactions. Accordingly, the '5% policy' does not apply to municipal securities transactions." MSRB Report on Pricing, at n.1.

[211] *Id*. at 3, ¶ 13.

[212] MSRB Rule G-17.

[213] *See Dep't of Enforcement v. SFI Invs. Inc.*, No. C10970176, 2000 NASD Discip. LEXIS 52, at *42-43 (O.H.O. Mar. 28, 2000) (citations omitted).

[214] *Orkin v. SEC*, 31 F.3d 1056, 1063 (11th Cir. 1994).

[215] *See SFI Invs., Inc.*, 2000 NASD Discip. LEXIS 52, at *43 (citing *First Honolulu Sec., Inc.*, 51 S.E.C. 695, 697 (1993).

actual transactions closely related in time to its retail sales in the same security are normally a highly reliable indication of prevailing market price."[216] In fact, DLA recently utilized the contemporaneous cost methodology to calculate markups of its municipal bonds in a submission to FINRA.[217]

A broker's contemporaneous cost is presumptively the fair market value, and Respondents have the burden to show otherwise.[218] Respondents did not meet this burden.[219] Here, the Identified Municipal Bond sales were very close in time to Respondents' purchases: the sales occurred on the same day that DLA purchased the municipal bonds, or the next business day.[220] Further, during the Municipal Bond Period, the municipal bond market was generally stable on a day-to-day basis.[221] The Hearing Panel finds that DLA's contemporaneous cost is the prevailing market price.

[216] *Dep't of Enforcement v. McLaughlin, Piven, Vogel Sec., Inc.*, No. C02980073, 1999 NASD Discip. LEXIS 51, at *24 (O.H.O. Dec. 1, 1999).

[217] CX-53 (DLA's Wells Statement relating to a more recent FINRA investigation that also involved municipal bond markups).

[218] *McLaughlin, Piven, Vogel Sec., Inc.*, 1999 NASD Discip. LEXIS 51, at *25-26 (citing *LSCO Sec., Inc.*, Exchange Act Rel. No. 26779, 1989 SEC LEXIS 781, at *4 (May 3, 1989); *Charles Michael West*, 47 S.E.C. 39, 42 (1979)); *SFI Invs., Inc.*, 2000 NASD Discip. LEXIS 52, at *43.

[219] McKinney explained that large block trades that "move the market" could constitute evidence of a change in the market price; however, McKinney did not find any trades that "moved the market" between DLA's purchase of municipal bonds and its retail sales. He explained that during the relevant period, the municipal bond market was generally stable on a day-to-day basis. Tr. 304.

[220] *See* CX-61; JX-1.

[221] Tr. 304.

3. Respondents' Arguments

a. *Market Reconstruction Approach*

Respondents presented Charles Cox, a former Commissioner of the Securities and Exchange Commission ("SEC"), as their expert in municipal bonds and CMOs.[222] Cox analyzed the Identified Municipal Bonds by attempting to "reconstruct" the market.[223] Pursuant to Cox's market reconstruction approach, Respondents' markups declined from the average of 4.19% (using contemporaneous cost) to 3.97%.[224]

According to Cox, markups must be calculated from the purported "market price" set by closest in time interdealer trades.[225] However, Mason acknowledged that he did not adjust retail municipal bond prices in response to every move in the market.[226] In fact, generally the Identified Municipal Bond prices changed very little, if at all, over the one-to-two day periods at issue in this case.[227] Additionally, Cox's analysis included interdealer trades before DLA's own purchase, which itself represents an interdealer trade.

Cox also acknowledged that Respondents' market reconstruction approach depends on the application of information that Mason did not know, and could not

[222] Tr. 1416. Cox never worked in the securities industry. Tr. 1642. Cox has not traded municipal bonds or CMOs, supervised the sale of municipal bonds or CMOs, or published any articles on markups. Tr. 1639-41. In developing his opinions, Cox did not discuss with Respondents how they determined the prevailing market price for municipal bonds. Tr. 1649. Cox did not know the data that Mason relied on when he priced the municipal bonds. Tr. 1663.

[223] *See* RX-3.

[224] RX-57, at 6.

[225] Tr. 1438, 1448-50, 1748.

[226] Tr. 707-15; *see*, *e.g*., CX-61, at 1, lines 1-8, 25-34; *id*. at 13, lines 521-529; *id*. at 17, lines 671-89.

[227] *E.g.*, CX-61, at 1, lines 1-8, 25-34; *id*. at 13, lines 521-529; *id*. at 17, lines 671-89.

possibly have known, at the time he set municipal bond retail prices.[228] For example, in approximately 470 of the Identified Municipal Bond trades, Cox set the "market price" of a municipal bond by using interdealer trades that occurred up to several days *after* the retail sale in question.[229] Further, in approximately 99 of the Identified Municipal Bond trades, Cox determined that "market price" could be based on an interdealer trade made within 15 minutes or less of the applicable Identified Municipal Bond retail sale.[230] DLA's retail sales, which are handled by its investment counselors, could not have reflected changes in market price so quickly.[231]

For the above reasons, the Hearing Panel finds that Respondents' market reconstruction approach is not reliable and rejects it.

b. *Comparison of Yield to MMD Scale*

Cox also compared the yields on the Identified Municipal Bond trades to the Municipal Market Data ("MMD") scale, a composite index that shows yields in institutional trades for bonds with various credit ratings.[232] However, Cox uniformly used

[228] RX-3; Tr. 1461-63, 1649-50. Mason disparaged Respondents' experts' market reconstruction efforts as constituting a "backwards" looking approach that failed to take into account the reality of his daily experience. Mason testified that he "heard somebody use the term reconstruct the market and they're trying to go backwards and look and apply different standards to what was going on at the time. . . ." Tr. 2842. The "somebody" advocating for a market reconstruction was Respondents' expert Robert Lowry. Tr. 1865.

[229] Tr. 1461-63, 1649-50; *see, e.g.*, RX-3, at 3, lines 94-111; *id.* at 6, lines 210-24; *id*. at 8-9, lines 297-310. Cox's approach would require Mason to have known entirely *new* information by foretelling future prices for specific instruments.

[230] RX-3. Cox did not determine if Respondents were aware of these trades when they priced their municipal bonds. Tr. 1665-66. In fact, he did not discuss with Respondents how they determined the prevailing market price. Tr. 1649-50.

[231] Any pricing changes Mason made could not affect retail trades made within 15 minutes. Once Mason changed a price, inventory sheets had to be updated and delivered to the investment counselors. Tr. 687-88. Then, an investment counselor would have to contact a customer, obtain an order, and process the order. Tr. 624 (stating bonds sold by DLA's registered representatives). Lastly, the order would have to be reported to the MSRB, which allowed firms to report up to 15 minutes after the trade. These steps could not all occur within 15 minutes.

[232] Tr. 1685. Cox learned about the MMD scale from Respondents' counsel. Tr. 1688.

the wrong MMD scales; he failed to recognize that the majority of the relevant municipal bonds were insured.[233] McKinney explained that Cox's reliance on the wrong MMD scales was fatal to his analysis because there are significant differences in the yields for "natural" bonds[234] and bonds that have the same credit rating because of insurance.[235]

The Hearing Panel rejects Respondents' comparison to the MMD composite index, and finds that the best comparison for the yields on the Identified Municipal Bonds is the yields provided to the MSRB from other brokers for those specific bonds.[236]

c. *Application of DBCC v. David Lerner Associates*

Respondents also assert that they relied on *DBCC v. David Lerner Associates*, a FINRA decision issued in 1981 (the "1981 case") where DLA was successful in defending unfair municipal bond pricing allegations, as a standard for measuring municipal bond markups.[237] Specifically, Respondents contend that the 1981 case set a "40 basis point standard" – as long as the yield to a customer was within 40 points of the yield at which DLA bought the bond, the trade was fair.[238]

---

[233] CX-10; Tr. 1689-98. Cox admitted that he was unfamiliar with the MMD scale prior to working on his report in this proceeding. Tr. 1687-88.

[234] "Natural" bonds are rare, premiere bonds that do not rely on insurance for their rating. Tr. 334-35. DLA did not sell "natural" triple A bonds. Tr. 334.

[235] Tr. 337-42. An insured bond could have a single A underlying rating but with the added insurance, it is rated triple A. Tr. 335.

[236] Cox never looked at the MSRB's data. Tr. 1682-84.

[237] Respondents' assertion that they relied on the 1981 case when setting the Identified Municipal Bond prices lacks credibility. During Mason's investigative testimony, he was questioned about all the factors he relied upon when setting municipal bond prices; yet, he never mentioned anything about the 1981 case. Tr. 666-67. At the hearing, Mason claimed that he had heard about the 1981 case approximately five times, including early in his career at DLA; however, prior to this hearing, he never read the entire case or reviewed the schedule of trades attached to the decision. Tr. 648, 665-66. Similarly, Reilly, a trader in the Trading Department, never mentioned the 1981 case during his investigative testimony, when asked if he used any guidelines when setting municipal bond prices. Tr. 2538-45. Respondents also failed to mention the 1981 case in their Wells letters when responding to: (1) FINRA's concerns in this case; (2) multiple additional FINRA inquiries; and (3) Wells letters regarding other municipal bond pricing. *See* CX-18, CX-19, CX-37, CX-45, CX-53.

[238] RX-57, at 10; Tr. 1503-04.

The Hearing Panel rejects Respondents' application of the 1981 case. First, the 1981 case did not create an industry "standard." Prior to being retained by Respondents, their expert Cox acknowledged that he had never heard of the 1981 case.[239] Second, the municipal bond market is vastly different now than it was in 1981.[240] Yields in 1981 were nearly twice as high as those during the Municipal Bond Period.[241] The bond market now is transparent, and such transparency has driven down markups.[242] Third, during the Municipal Bond Period, DLA's Compliance Department should have been aware that since 1981 even markups lower than those at issue have been found to be excessive.[243] Fourth, while Mason stated that he relied on the 1981 case, he admitted that he never read it or reviewed the markup schedule attached to the case.[244] In conclusion, the Hearing Panel finds that DLA's 1981 "standard" could not reasonably be relied on between 2005 and 2007.

[239] Tr. 1715-16.

[240] Tr. 273-74, 283-93, 297-98; 1816-18.

[241] The bonds at issue in 1981 had yields ranging from approximately 7% to 10%, with most in the 8% to 9% range. Tr. 291; RX-5, at 8-16. In contrast, most of the relevant bonds in this proceeding traded at yields in the 4.5% to 5% range. Tr. 292-93, 297-98; *See* CX-1, at 8-15. A 40 basis point yield reduction would have a commensurately greater impact on yield today: a 40 basis point reduction from the 1981 yield of 8% to 7.60% is a 5% reduction in yield to the customer; in contrast, a 40 basis point reduction from the 2005 yield of 4.5% slashes the yield by almost 9%. As such, DLA's "standard" has a much more severe impact when it is applied to bonds with lower yields. Both Mason and Cox lacked credibility when responding to questions regarding the impact of 40 basis points as applied to bonds with lower yields. Both contended, essentially, that "40 basis points is 40 basis points." Tr. 664-65; 1723-24.

[242] Tr. 273-74. Mason acknowledged that, unlike in 1981, the bond market now is transparent. Tr. 634-35.

[243] *See, e.g.*, *Mark David Anderson*, 56 S.E.C. 840 (2003) (finding municipal bond markups ranging from 1.87% to 5.64% and CMO markups ranging from 1.42% to 4.04% to be excessive); *Dist. Bus. Conduct Comm. v. Mid-State Sec. Corp.*, 1989 NASD Discip. LEXIS 58, at *12-13 (Aug. 8, 1989) (NASD Board of Governors affirming finding of District Committee that municipal bond markups ranging from 2.4% to 4.4% were "not fair and reasonable considering all relevant factors").

[244] Tr. 648, 665-66.

d. *Comparison to Mutual Fund Loads*

Cox also contended that Respondents' markups compared favorably to mutual fund loads.[245] The Hearing Panel rejects the comparison of these two different products. Notably, mutual fund loads are disclosed to customers whereas Respondents' markups were not.[246]

e. *Exceptional Services*

Finally, Respondents contended that the municipal bond markups were justified based on the exceptional services they provided. As stated above, there is no evidence that services provided by DLA to its municipal bond and CMO customers were superior to those provided by other municipal bond dealers in the market.[247] Plus, the municipal bonds at issue were purchased and sold within a very short time period, at times within hours.[248] While Mason claimed to have factored DLA's services into his pricing, he admitted he was not aware of all the services DLA provided or the services provided by other firms.[249] Accordingly, the Hearing Panel finds that Respondents' markups are not justified by their asserted "exceptional services."

4. Conclusion

The Hearing Panel accepted McKinney's analysis over that of Respondents' experts for the reasons discussed above. The Hearing Panel finds that the Identified

[245] Tr. 1533-35; RX-57, at 10-13. In Respondents' Wells submission, they never sought to justify their markups based on a comparison to mutual funds. CX-18, CX-19.

[246] Tr. 319.

[247] Tr. 802-04. Respondents' expert Cox conducted no investigation of DLA's services relative to other dealers' services. Tr. 1701-02. The Hearing Panel did not find Mason's testimony regarding DLA's services to be credible. *See supra* footnote 96. McKinney testified that William Blair provided the same types of services as DLA; yet, its markups are far lower. Tr. 274-76, 317.

[248] *See, e.g.*, JX-1, at 1, lines 1-6 (DLA purchases at 11:19 and sells to customers at 14:43), *id.* at lines 25-26 (DLA purchases bonds at 10:03 and sells to customers at 12:54).

[249] Tr. 698-99.

Municipal Bond prices were unfair and that Respondents' markups were excessive. While DLA is entitled to a profit, Respondents did not present any evidence that their excessive markups were necessary for DLA to earn a profit. In fact, the Trading Department never had an unprofitable month during the Municipal Bond Period.[250] Respondents knew how the market was pricing the bonds sold to their customers, but chose to charge their customers unfair prices that were much higher than those charged by other market participants, resulting in lower yields for their customers. Accordingly, the Hearing Panel finds that Respondents violated MSRB Rules G-30 and G-17, as alleged in the First Cause of Action.

A finding of willfulness does not require a determination that Respondents intended to violate FINRA's or MSRB's rules.[251] Rather, the Hearing Panel need only find that Respondents voluntarily committed the act that constituted the violation,[252] i.e., charging unfair prices on the Indentified Municipal Bonds. Accordingly, the Hearing Panel finds that Respondents' conduct was willful.

B. CMO Markups

1. Legal Standard

NASD Conduct Rule 2440 requires Respondents to sell securities to their customers "at a price which is fair, taking into consideration all relevant circumstances." Under the Rule, relevant circumstances include: (a) market conditions with respect to such security at the time of the transaction; (b) the expense involved; and (c) the fact that the broker is entitled to a profit.

---

[250] Tr. 628. Most of the Trading Department's profit came from retail sales. *Id.*

[251] *Dep't of Enforcement v. Kraemer*, No. 2006006192901, 2009 FINRA Discip. LEXIS 39, at *16 (N.A.C. Dec. 18, 2009).

[252] *Id.*

NASD's markup policy, IM-2440-1, states that "[i]t shall be deemed a violation of [NASD] Rule 2110 and Rule 2440 for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable."[253] The markup policy originates from the fundamental principle that, in dealings with its customers, a securities dealer impliedly represents that it will deal with them honestly and fairly and in accordance with the established standards of the business, which representation is rendered false when the dealer charges prices not reasonably related to the prevailing market prices without disclosing that fact.[254] The policy likewise incorporates the long-held standard that "any person, regardless of his knowledge of the market or his access to market information, is entitled to rely on the implied representation, made by a registered dealer in securities, that customers will be treated fairly."[255]

IM-2440-1 sets forth some additional factors that "should" be taken into consideration in determining the fairness of Respondents' markups. Those factors are: (1) the type of security involved; (2) the availability of the security in the market; (3) the price of the security; (4) the amount of money involved in the transaction; (5) disclosure; (6) the pattern of markups; and (7) the nature of the member's business.[256] "While each transaction must meet the test of fairness, the Board believes that particular attention

---

[253] IM-2440-1.

[254] *See, e.g., Charles Hughes & Co., Inc. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943). According to the shingle theory, a broker-dealer impliedly represents at the outset of a securities transaction that it will deal with its customers fairly and in accordance with the standards of the industry. *Duker & Duker*, 6 S.E.C. 386, 388-89 (1939).

[255] *United Sec. Corp.*, 15 S.E.C. 719, 727 (1944).

[256] IM-2440-1(b).

should be given to the pattern of a member's mark-ups."[257] As the SEC explained, a pattern of high markups establishes a *prima facie* case of improper markups.[258]

2. Prevailing Market Price

IM-2440(a)(3) provides that "[i]n the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security." As with municipal bonds, Respondents must overcome the presumption that the CMO markups should be calculated based on the firm's contemporaneous cost. Although DLA contends that the application of contemporaneous cost is inappropriate, DLA used contemporaneous cost to calculate CMO markups when responding to an SEC inquiry regarding CMO markups, most of which are the Identified CMOs at issue in this case.[259] Here, the retail CMO sales occurred within one business day of DLA's purchase of the Identified CMOs. The Hearing Panel finds that DLA's contemporaneous cost (i.e., the firm's purchase price) is the best indicator of the prevailing market price.

3. Respondents' Arguments

a. *Market Reconstruction Approach*

Respondents' claim that their CMO markups were appropriate relies in significant part on their lower calculation of markups, based on their "reconstruction" of the CMO

[257] IM-2440-1(b)(6)

[258] *Inv. Planning, Inc.*, 51 S.E.C. 592, 596 n.19 (1993).

[259] DLA created RX-59 in response to CX-66, an SEC request, dated November 20, 2007, seeking information regarding DLA's markups on CMO retail trades between January 1, 2006 and August 31, 2007, which constitute most of the Identified CMO markups. When the SEC requested that DLA calculate its markups, DLA used its contemporaneous cost. Tr. 1381-87.

market.[260] Using their CMO market reconstruction approach, Respondents calculated the markups for approximately 726 of the Identified CMO trades (approximately 42%). For the remaining CMO trades, where there was no evidence of any relevant interdealer trades in the CMO CUSIPs at issue,[261] Respondents added an "imputed market maker's spread" of 0.67% to DLA's contemporaneous cost, and argued that the resulting sum is the market price against which the markups should be measured.[262] The Hearing Panel finds Respondents' market reconstruction approach unreliable and rejects it for several reasons.

First, their CMO market reconstruction contains many of the same problems as their municipal bond market reconstruction. For example, it relies on interdealer trades that occurred *after* the retail sales, which Mason could not have known when pricing the Identified CMOs.[263] Further, because the CMO data contains only the date, without the specific time of the trade,[264] it is not possible to determine the sequence of several trades executed on a particular day.[265]

---

[260] RX-24. Respondents' "reconstruction" is based on trading data provided by approximately 80 firms chosen by Respondents. The Hearing Officer granted Respondents' request to obtain interdealer trading data from 80 firms. *See* Order Granting Respondents' Rule 9252 Request and Directing Enforcement to Issue Rule 8210 Requests, dated Feb. 23, 2011. Respondents' request was not limited in any manner. *Id.*

[261] In approximately 1,020 of the 1,746 Identified CMO trades, there were no interdealer traders (at DLA or away from DLA) between the time of DLA's purchase and DLA's sale of the CMO at issue. Tr. 904-06, 1755-56. In approximately 200 of the CMO trades, there were no interdealer trades (at DLA or away from DLA) at prices higher than DLA's contemporaneous cost between the time of DLA's purchase and DLA's sale. Tr. 905-06; CX-40.

[262] Tr. 1765. Cox did not rely on any information from Mason when determining whether to apply the "imputed market maker spread." Tr. 1766. Mason disagreed with Respondents' experts' application of the "imputed market maker spread." Tr. 2949-50.

[263] Tr. 777-78.

[264] Tr. 2064.

[265] Tr. 761.

Second, unlike the municipal bond market, the CMO market is not even partially transparent. Accordingly, Mason could not have known about any of the trades, other than the Trading Department's purchases.[266] Cox's methodology utilized interdealer trades regardless of whether Mason was aware of them at the time.[267]

Third, Cox did not consistently apply his methodology. When Cox encountered closer in time interdealer trades at prices less than or equal to DLA's acquisition cost (i.e., contemporaneous cost), he ignored them and instead applied the imputed market maker spread of 0.67, which resulted in lower markup calculations.[268]

Lastly, Respondents' "market reconstruction" approach relies on the incorrect assertion that DLA was a market maker in CMO securities.[269] Respondents' expert Robert Lowry testified that DLA was a market maker in CMOS.[270] Lowry justified his assertion that DLA is a "market maker in CMO securities" on the ground that the firm bought and sold many CMOs on an interdealer basis during the relevant period.[271] However, firms make markets in *particular* securities, not entire categories of securities. The Securities Exchange Act of 1934 ("Exchange Act") defines a market maker as one who "with

---

[266] While Mason testified that he could know about interdealer trades even though DLA did not participate in them, he did not change the Identified CMO prices in response to interdealer trades. Tr. 755; *compare* CX-62, at 2, lines 46-63 *with* CX-40, at 2; *compare* CX-62, at 3-4, lines 135-177 *with* CX-40, at 5.

[267] Tr. 1764-65.

[268] Tr. 1780-88; *compare* RX-17 *with* CX-62 and CX-6.

[269] Tr. 2024. The Hearing Panel finds that Respondents asserted market maker status lacks credibility. Presumably, had DLA been a market maker, Respondents would have notified FINRA (in their Wells response in this case) and the SEC (when responding to an SEC inquiry on August 17, 2009 regarding DLA's CMO pricing) of their market maker status. They did not do so. *See* CX-50, at 2; CX-18, at 20; CX-19. Akerman, DLA's CCO, authored the SEC response and testified that he intended the letter to be "accurate and thorough." Tr. 570-71. In preparing the SEC response, Akerman consulted with the relevant DLA employees, including Mason. Tr. 570.

[270] Lowry worked at the SEC until 1995. He worked in the securities industry for one year between 1995 and 1996; however, he never obtained his registrations. Tr. 1974-76. His employment in the securities industry was unrelated to CMO sales to retail customers. Tr. 1977.

[271] Tr. 2032-33 (DLA's market maker status based on the "overall characteristics of the office").

respect to *a security*, holds himself out (by entering quotations in an interdealer communications system or otherwise) as being willing to buy and sell *such security* for his own account on a regular or continuous basis."[272] Accordingly, Respondents must demonstrate market maker status on a CMO-by-CMO basis.

While Lowry admitted that, in order to determine whether DLA was a market maker, one would have to look at each CMO CUSIP and determine the trading activity in that particular CMO,[273] he never conducted such an analysis. Lowry acknowledged that every CMO is unique and has its own characteristics,[274] but his analysis ignored that fact and he failed to conduct the security-by-security analysis as required by the Exchange Act. In fact, Respondents failed to show that DLA was a market maker in even one of the specific relevant CMO CUSIPs. Instead, Lowry's analysis aggregated CMOs traded by Respondents on an issuer-by-issuer basis, without regard to the characteristics of the CMOs. For example, Lowry's analysis included many CMOs issued by Countrywide; however, he analyzed them as if they were all the same security.[275]

Lowry admitted that he had never before deemed a firm to be a market maker in CMOs. Indeed, Respondents have not cited any reported decision that has ever held a firm to be a market maker in CMOs generally or in any particular CMO. A market maker is required to buy at its stated bid price and sell at its stated offer price. In contrast, DLA's CMO trader, DeArce, testified that he bought CMOs from other dealers at his bid price only when he was able to do so; if he could not get the CMO at his bid, he simply

[272] Section 3(a)(38) of the Securities Exchange Act of 1934 (emphases added).

[273] Tr. 2031.

[274] Tr. 2028-34.

[275] *See* RX-22 (many different CMOs issued by Countrywide were analyzed as if they were all the same security even though any given issuer sold a wide variety of CMOs, with varying characteristics and maturities).

did not buy it.[276] Further, in a two-sided market, a market maker must show both its bid and its offer prices. However, DLA never showed both its bid and offer prices at the same time.[277] In addition, registration is required for market makers whereas there is no such market maker registration for CMOs.[278] Simply put, the traditional hallmarks of a market maker are not present here.

b. *5% Policy*

Respondents contend that markups under 5% complied with FINRA's "5% Policy" and thus were fair.[279] The Hearing Panel rejects this argument. At the outset, IM-2440 clearly states that the 5% Policy "is a guide, not a rule"[280] and that "[a] mark-up pattern of 5% or even less may be considered unfair or unreasonable under the '5% Policy.'"[281] For example, as Levin noted, no one could reasonably claim that a 5% markup on a Treasury bond would be fair.[282] Levin explained that she would never have added such a high markup to a CMO,[283] and, for the Identified CMOs, a 5% markup (or even a 4% markup) was simply unfair.[284] Indeed, prior to the CMO Period, the SEC found CMO markups ranging from 1.42% to 4.04% to be excessive.[285]

---

[276] Tr. 2209-11.

[277] Tr. 2211-13.

[278] Tr. 1123 (no "list of market makers" on Bloomberg). In addition, DLA's confirmation statements did not identify it as a market maker. RX-18A; Tr. 771.

[279] Respondents' argument that they set their prices to comply with the 5% Policy is not credible because many of the Identified CMOs markups greatly exceeded 5%. *See* CX-62.

[280] IM-2440-1(a)(1).

[281] IM-2440-1(a)(4).

[282] Tr. 1193-94.

[283] *Id.*

[284] Tr. 1178-80.

[285] *Mark David Anderson*, 56 S.E.C. at 852, 860-62.

Plus, the determination of whether a markup is fair is based on "all the relevant factors, of which the percentage of mark-up is only one."[286] Respondents' argument fails to consider the type of security involved. For a CMO, which is akin to a bond, the markup would typically be lower than the markup on, for example, shares of common stock.[287]

c. *Comparison to FINRA/ Bloomberg Corporate Bond Index*

Respondents also rely on Cox's comparison of their CMO yields to the FINRA/Bloomberg Corporate Bond Index ("Bond Index").[288] However, the Identified CMOs are not comparable to the Bond Index. The securities in the Bond Index are principally corporate bonds with ratings of AA or A. As Olvany explained, the Identified CMOs are primarily support and sequential pay bonds (177 of the 185 relevant CMOs), which have greater risk due to their relatively volatile prepayment speeds.[289] While the remaining eight CMOs were "PAC" bonds, which Olvany acknowledged were comparable to the bonds in the Bond Index, they represented a small fraction of the Identified CMOs. Accordingly, the majority of Cox's comparison did not account for the fact that the yields on the Identified CMO trades should have been significantly higher than the Bond Index yields.[290] For the above reasons, the Hearing Panel finds that Cox's comparison is unreliable.

[286] IM-2440-1(a)(5).

[287] *See* IM-2440-1(b)(1). DLA offered only the top of the line and most conservative CMOs. Tr. 719.

[288] Tr. 1620; *see* RX-57, at 21-22.

[289] Tr. 1076.

[290] Mason acknowledged that he never priced CMOs based on the Bond Index. Tr. 749. Neither did Levin. Tr. 1194.

d. *Comparison to Mutual Fund Loads*

Cox made the same mutual fund load comparison as he did for municipal bonds. In contrast to mutual funds, DLA never disclosed the markups on its CMOs.[291] The Hearing Panel rejects this argument based on the differences between the products.

e. *Exceptional Services*

As with the municipal bonds, Respondents contend that their markups were justified by the services they provided. The Hearing Panel rejects this argument for the same reasons delineated in the above section on municipal bonds. Further, as Levin explained, DLA provided "standard services that all" brokers provide.[292]

4. Conclusion

The Hearing Panel accepted Levin's and Olvany's analysis over that of Respondents' experts for the reasons discussed above. The Hearing Panel also considered the relevant factors in NASD Conduct Rule 2440 and IM-2440-1 and concluded that Respondents charged unfair prices on the Identified CMOs. The CMOs were readily available in the market. Respondents' markups exhibited a pattern; the markups were primarily in the 4.0% to 6.0% range regardless of the specific characteristics of the transactions or the type of security. By charging unfair CMO prices, which were not disclosed, Respondents significantly reduced the yields for their customers. While Respondents are entitled to a profit, they did not present any evidence that their excessive markups were necessary for DLA to earn a profit.[293] Further, nothing in the nature of DLA's business entitled Respondents to charge high markups. The Identified CMO

[291] Tr. 688, 746, 2618.

[292] Tr. 1178.

[293] The Trading Department never had an unprofitable month during the CMO Period. Tr. 628.

prices were unfair and Respondents' markups were excessive. Accordingly, the Hearing Panel finds that Respondents violated NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110, as alleged in the Fifth Cause of Action.

C. Time of Receipt on Municipal Bond Customer Orders

MSRB Rule G-8(a) lists certain "books and records required to be made" by brokers and dealers of municipal securities. Rule G-8(a)(vii) requires, "in the event such purchase or sale [of municipal securities] is with a customer, a record of the customer's order, *showing the date and time of receipt*" of the order and additional information."[294] This requirement "is designed to allow the dealer and the appropriate examining authority to determine whether the dealer has complied with rule G-18, on execution of transactions, and rule G-30, on pricing," because those rules require dealers to charge customers fair and reasonable prices, taking into account, among other things, "the market value of the securities at the time of the transaction."[295]

DLA failed to comply with the requirement in 2,307 instances between April 13 and June 30, 2005.[296] Accordingly, DLA violated MSRB Rule G-8. Applying the above standard for willfulness, the Hearing Panel finds that DLA's violation was willful.[297]

---

[294] MSRB Rule G-8(a)(vii) (emphasis added).

[295] MSRB Interpretive Letters on Rule G-8, Interpretation of April 20, 1987 ("Time of receipt and execution of orders"); available at www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-8.

[296] CX-12.

[297] *See supra* footnotes 251 and 252 and accompanying text (discussing standard for finding of willfulness).

D. Supervisory Systems and Procedures

1. Legal Standard

"Assuring proper supervision is a critical component of broker-dealer operations."[298] MSRB Rule G-27 requires Respondents to "establish and maintain a system to supervise the municipal securities activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable Board rules."[299] NASD Conduct Rule 3110(a) is nearly identical to MSRB Rule G-27, and requires Respondents to establish a "system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."[300] The standard of "reasonableness" is determined based on the particular circumstances of each case.[301] A violation of Conduct NASD Conduct Rule 3110 also is a violation of NASD Conduct Rule 2110, which requires member firms to observe high standards of commercial honor and just and equitable principles of trade.[302]

2. Municipal Bonds and CMOs

DLA's supervisory system for its municipal bond and CMO pricing was inadequate on several levels. At the outset, DLA designated Mason as the supervisor for the Trading Department, which resulted in self-supervision as Mason reviewed his own

[298] *Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *27 (June 29, 2007).

[299] MSRB Rule G-27(b).

[300] NASD Rule 3010(a).

[301] *See, e.g., Christopher Benz*, 52 S.E.C. 1280, 1284 (1997) (citing *Consol. Inv. Servs., Inc.*, 52 S.E.C. 582 (1996).

[302] *Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *33 (Dec. 19, 2008) (citation omitted); *Dep't of Enforcement v. Midas Securities, LLC*, No. 2005000075703, 2011 FINRA LEXIS 71, at *22-23.

markups.[303] DLA also failed to provide Mason with (1) any formal training on pricing municipal bonds or CMOs and (2) relevant markup case law. Further, Mason's compensation depended in part on the revenue generated by the Trading Department, so he had a financial incentive to set the highest prices possible in order to boost revenues. While Mason testified that Lerner, DLA's president, was his supervisor,[304] there is no evidence that Lerner supervised Mason during the relevant periods. Left unsupervised, he overcharged customers. DLA also profited from Mason's unfair prices. Simply put, DLA failed to properly supervise Mason's municipal bond and CMO pricing.

As demonstrated above, the Identified Municipal Bond and CMO sales were at unfair and excessive prices, and violated MSRB Rule G-30 and NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110. DLA's investment counselors utilized Respondents' unfair prices when selling the municipal bonds and CMOs to DLA's customers. In comparison to the publicly available MSRB data, Respondents' prices signaled a red flag because they were significantly higher than other industry participants. Although the CMO market lacked the transparency of the municipal bond market, there was other information, such as yield spread data, to enable Respondents to properly supervise their CMO pricing and ensure their customers were charged fair prices. Respondents knew, or should have known, that the markups set on CMOs of shorter duration would have a greater impact on yield than equivalent markups on CMOs of longer duration. Respondents ignored the market information and set markups very close to 5%, regardless of the security or the relevant market conditions.

---

[303] The SEC has consistently recognized that a registered representative cannot supervise his own activities. *See, e.g.*, *Harry Gliksman*, 54 S.E. C. 471, 485 (1999), *aff'd*, 24 F. App'x 702 (9th Cir. 2001); *Bradford John Titus*, 52 S.E.C. 1154, 1158 (1996).

[304] Tr. 793.

DLA's Compliance Department played a limited and ineffective role in reviewing municipal bond and CMO pricing. DLA's Compliance Department did not generate any surveillance reports relating to the Identified Municipal Bonds and CMOs. While it conducted periodic spot checks of the trades, it limited its review to trades with markups that were more than 5% above market price.[305] Given that a markup need not exceed 5% in total markup to be unfair to customers, spot checking prices where the markup was greater than 5% resulted in a review of only a sample of the most egregiously priced trades. Indeed, many of the unfair Identified CMO trades had markups under 5%. Moreover, because the Compliance Department's review was a periodic spot check many trades with markups higher than 5% above the market price were never reviewed at all.[306]

Lerner was responsible for supervising DLA's policies and procedures.[307] During the relevant period, DLA, through Lerner, failed to ensure that the firm had adequate policies and procedures. Ninety-five percent of the Trading Department's business related to municipal bonds and CMOs;[308] yet, DLA's WSPs were not reasonably designed to supervise Respondents' municipal bond and CMO pricing and ensure compliance with the applicable regulations. As discussed above, DLA's procedures were inadequate in a number of ways, including, but not limited to: (1) the designation of Mason as the supervisor of the Trading Department, (2) the utilization of the incorrect factors to review CMOs, and (3) for at least part of the review periods, the failure to require the firm to charge "fair" prices to customers.

---

[305] Tr. 545-46, 553.

[306] Tr. 545-46, 553.

[307] RX-47, at 11; CX-8, at 11.

[308] Tr. 605.

The Hearing Panel finds that DLA willfully failed to supervise its municipal bond pricing and establish reasonable procedures to monitor the fairness of the municipal bond pricing, in violation of MSRB Rule G-27, as described in the Third Cause of Action.[309] The Hearing Panel also finds that DLA failed to supervise its CMO pricing and establish reasonable procedures to monitor the fairness of the CMO pricing, in violation of NASD Conduct Rules 3010(a) and 2110, as described in the Sixth Cause of Action.

The Fourth and Sixth Causes of Action allege that Mason failed to reasonably supervise the municipal bond and CMO pricing. However, because Mason is "substantively responsible" for the misconduct alleged in First and Fifth Causes of Action of the Complaint, he cannot also be responsible "for inadequate supervision with respect to those violations."[310] Accordingly, the Fourth Cause of Action is dismissed, and the Sixth Cause of Action is dismissed solely as it relates to Mason.[311]

3. Municipal Bond Order Tickets

DLA also failed to implement procedures reasonably designed to ensure it complied with the MSRB Rule G-8(a)(vii) requirement that it record the time of the customer purchase of municipal bonds. DLA's failure to address this requirement in its WSPs is consistent with DLA's complete failure to comply with the MSRB's mandate that it record the time of the customer order. DLA's employees, including Akerman, DLA's then-Director of Compliance (and later CCO), testified that DLA simply did not

[309] *See supra* footnotes 251 and 252 and accompanying text (discussing standard for finding of willfulness).

[310] *See Dep't of Enforcement v. Block*, No. C05990026, 2000 NASD Discip. LEXIS 33, at *26-27 (O.H.O. Sept. 5, 2000) (quoting *Market Surveillance Comm. v. Markowski*, No. CMS920091, 1998 NASD Discip. LEXIS 35, at *52-53 (N.A.C. July 13, 1998)); *Anthony J. Amato*, 45 S.E.C. 282, 286-87 (1973) (setting aside NASD's finding that respondent failed to supervise in light of respondent's active role in primary violation).

[311] If Mason had not been charged as a primary violator under the First and Fifth Causes of Action, the Hearing Panel would conclude that Mason committed the supervisory violations.

record that information. The Hearing Panel finds that DLA willfully failed to implement a reasonable supervisory system and procedures to ensure compliance with MSRB Rule G-8(a)(vii), in violation of MSRB Rule G-27.[312]

V. SANCTIONS

A. Municipal Bond and CMO Markups

1. Sanction Guidelines

The FINRA Sanction Guidelines ("Guidelines") recommend a fine of $5,000 to $100,000 for matters involving excess markups in violation of NASD Conduct Rule 2440, IM-2440, and MSRB Rule G-30.[313] For individual respondents, the Guidelines for excessive markups suggest a suspension in any or all capacities for up to 30 business days, but recommend consideration of a longer suspension (up to two years or a bar) in egregious cases.[314]

2. Principal Considerations

The Hearing Panel applied the Principal Considerations in Determining Sanctions and found several aggravating factors relevant to this proceeding.[315] The Hearing Panel reviewed DLA's disciplinary history and found that it had engaged in past misconduct that "evidences disregard for regulatory requirements."[316] DLA's relevant disciplinary history consists of the following: In February 2006, DLA entered into an Acceptance Waiver and Consent ("AWC") with FINRA containing findings that DLA violated Section 17(a) of the Exchange Act, Rules 17a-3 and 17a-4 promulgated thereunder, and

---

[312] *See supra* footnotes 251 and 252 and accompanying text (discussing standard for finding of willfulness).

[313] *FINRA Sanction Guidelines* 90 (2011), www.finra.org/sanctionguidelines.

[314] *Id.*

[315] *Id.* at 6-7.

[316] *Id.* at 6 (Principal Consideration No. 1).

NASD Rules 1021, 2110, 3010, and 3110, by effecting variable life insurance and variable annuity replacement sales to public customers in contravention of New York State Insurance Department Regulation 60 ("Regulation 60"). In addition, DLA failed to observe high standards of commercial honor and just and equitable principles of trade and failed to prepare and maintain accurate books and records of variable life insurance and variable annuity replacement sales subject to Regulation 60. The AWC also stated that DLA, acting through an individual, permitted a registered representative to function as a principal without being properly registered in a principal capacity. FINRA also found that DLA, acting through representatives, failed to reasonably supervise the activities of its associated persons and registered representatives related to variable life insurance and variable annuity replacement sales subject to Regulation 60. Pursuant to the AWC, DLA accepted a censure, a $400,000 fine, and a suspension from engaging in any variable life insurance or variable annuity business for 30 days for new customers.[317]

In April 2004, DLA entered into an AWC with FINRA containing findings that it conducted sales contests in which DLA favored certain proprietary mutual funds or variable annuity contracts distributed or offered by DLA, in violation of NASD's mutual fund and variable contract non-cash compensation provisions of NASD Conduct Rules 2830 and 2820, as well as NASD Conduct Rule 2110. Additionally, the AWC contained findings that DLA failed to establish and maintain a supervisory and compliance system or procedures governing the non-cash compensation provisions, in violation of NASD

[317] *See* CX-9, at 53-54.

Conduct Rules 3010 and 2110. Pursuant to the AWC, DLA accepted a censure and a $100,000 fine.[318]

In determining sanctions, the Hearing Panel considered DLA's prior warnings from FINRA. The MSRB Rule G-30 violation relating to municipal bond markups is a repeat violation from a 2004 routine examination in which DLA received a Letter of Caution.[319] Specifically, FINRA found that DLA charged excessive markups of more than 3.75% on 17 municipal securities transactions.[320] The markups at issue ranged from 3.86% to 4.94%[321] The Letter of Caution advised the firm that "repeat violations will be taken into consideration in determining any future matter."[322] Notwithstanding this warning, Respondents charged DLA customers excessive markups on municipal bonds and CMOs throughout the respective relevant periods and beyond.[323]

The Hearing Panel finds that Respondents have neither acknowledged nor accepted responsibility for the misconduct at issue in this matter.[324] Instead, despite Respondents' awareness of FINRA's concerns about their markups practices, they continued to charge excessive markups. Specifically, Respondents' misconduct continued after FINRA provided the Wells notices to them in July 2009, which stated that Enforcement had preliminarily determined to pursue the charges in this case. For example, on January 29, 2010, in a separate investigation, FINRA informed DLA that it made preliminary determinations to recommend that disciplinary actions be brought

[318] *See id.* at 38-39.

[319] CX-46; *see* CX-44 and CX-45.

[320] CX-46, at 5.

[321] CX-44, at 2-3.

[322] CX-46, at 5.

[323] *Guidelines*, at 7 (Principal Consideration No. 15).

[324] *Id.* at 6 (Principal Consideration No. 2).

against it for unfair and unreasonable municipal bond pricing with respect to nine transactions, in violation of MSRB Rules G-17 and G-30.[325] In fact, even after Enforcement filed the Complaint in this proceeding in May 2010, FINRA's Department of Market Regulation detected DLA transactions with markups exceeding 3% in which the firm bought and sold the municipal bond on the same day.[326] Respondents' disregard for the security industry's regulatory requirements is evident through Respondents' refusal to take responsibility for their misconduct and their continued unfair pricing practice.

In keeping with their unwillingness to accept responsibility, Respondents have not taken any corrective measures to improve their fixed income markups policies and practices. The evidence indicates that DLA continues to charge their customers excessive markups on fixed income products.[327] There is no evidence that Respondents have made any attempt to pay restitution to the affected customers or otherwise remedy their misconduct.[328]

The Hearing Panel observed that this case involves "numerous acts" that form a "pattern of misconduct" involving excessive markups on the Identified Municipal Bonds and CMOs over an "extended period of time."[329] During the 25-month Municipal Bond Period, Respondents charged unfair and unreasonable prices with respect to 1,522

---

[325] CX-52.

[326] CX-54; *see also* CX-52 and CX-53 (Wells notice and response regarding recent municipal bond trades).

[327] *Guidelines*, at 6 (Principal Consideration No. 3).

[328] *Id.* (Principal Consideration No. 4).

[329] *Id.* (Principal Consideration Nos. 8 and 9); *see id.* at 7 (Principal Consideration No. 18: "The number, size and character of the transactions at issue").

municipal bond transactions,[330] with markups ranging from 3.01% to 5.78%. During the 32-month CMO Period, Respondents charged unfair and unreasonable prices with respect to 1,746 CMO transactions, with markups ranging from 4.02% to 12.39%.

Respondents' pattern of excessive markups was intentional or, at a minimum, extremely reckless.[331] In particular, during the Municipal Bond Period the municipal bond market was entirely transparent. Respondents admitted to closely monitoring trade activity, and thus were very aware of current market prices. Notwithstanding this knowledge, when setting retail prices, Respondents consistently and significantly imposed excessive, undisclosed markups on their customers. In addition, Respondents had sufficient information regarding the CMO market to have been aware that they were significantly overcharging their customers for CMOs. Instead, they engaged in a consistent pattern of markups, the majority of which hovered around 5%.

Respondents' excessive municipal bond and CMO markups caused customer harm in the form of overcharges, from which Respondents financially benefitted.[332] Indeed, the significant quantifiable customer losses totaled $765,345.28 on municipal bond transactions[333] and $692,731.24 on CMO transactions,[334] exclusive of pre-judgment interest.[335]

---

[330] This number excludes the 16 transactions that the Hearing Panel disregarded. *See supra* footnote 8.

[331] *Guidelines*, at 7 (Principal Consideration No. 13).

[332] *Id.* at 7 (Principal Consideration No. 17).

[333] *See* CX-5. The Hearing Panel reduced the total restitution amount to reflect the removal of the 16 transactions referenced in footnote 8.

[334] CX-6.

[335] *Guidelines*, at 11 (Restitution – Payment of Interest).

3. Conclusion

After careful consideration, the Hearing Panel finds that Respondents' markup violations are egregious due to the amount of customer harm, the number of transactions at issue, the extended time period of the violative trades, and the intentional, or at least reckless, nature of the misconduct. In light of the scope and severity of the misconduct, a substantial fine is appropriate. For Respondents' municipal bond and CMO markup violations, the Hearing Panel fines DLA a total of $2 million and Mason a total of $200,000.

Regarding the municipal bond markups, in violation of MSRB Rules G-30 and G-17, DLA is fined $1 million. DLA is also required to pay restitution to the customers associated with the Identified Municipal Bond trades specified in Schedule A to this decision, in the total amount of $765,345.28,[336] plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from the date of the municipal bond customer sale until the date that restitution is paid.[337] Each customer shall be repaid the amount shown in the column labeled "Excess Markup" on Schedule A to this decision, plus interest.[338] DLA is ordered to pay the restitution within 60 days of the effective date of this Decision. DLA is required to provide to Enforcement proof of payment for each Identified Municipal Bond trade; if DLA cannot locate a customer, DLA must provide proof that it has made a bona fide attempt to locate the customer. Any amount of restitution not paid to customers shall be paid to FINRA in the form of a fine. The Hearing Panel eliminates the interest requirement on any sums paid to FINRA as a

[336] CX-5. This restitution amount is reduced to reflect the removal of the trades identified in footnote 8.

[337] *Guidelines*, at 4 (General Principles Applicable to All Sanction Determinations).

[338] *Cf. Dist. Bus. Conduct Comm. v. Reed*, No. C06910024, 1995 NASD Discip. LEXIS 240, at *14, *19 (Jan. 11, 1995) (awarding restitution to customers involved in transactions in attached markup schedule).

fine.[339] For the municipal bond markups, Mason is fined $100,000 and suspended from associating with any member firm in any capacity. The majority determined that a 6-month suspension was the appropriate remedial sanction for Mason. The Hearing Officer dissents as to the length of Mason's suspension and would suspend Mason for 18 months.

Regarding the CMO markups, in violation of NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110, DLA is fined $1 million. DLA is also required to pay restitution to the customers associated with the Identified CMO trades specified in Schedule B to this decision, in the total amount of $692,731.24, plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from the date of the CMO customer sale until the date that restitution is paid. Each customer shall be repaid the amount shown in the column labeled "Excess Markup" on Schedule B to this decision, plus interest. DLA is ordered to pay the restitution within 60 days of the effective date of this Decision. DLA is required to provide to Enforcement proof of payment for each Identified CMO trade; if DLA cannot locate a customer, DLA must provide proof that it has made a bona fide attempt to locate the customer. Any amount of restitution not paid to customers shall be paid to FINRA in the form of a fine. The Hearing Panel eliminates the interest requirement on any sums paid to FINRA as a fine. For the CMO markups, Mason is fined $100,000 and suspended for 6 months from associating with any member firm in any capacity, which will run concurrently with Mason's suspension associated with the municipal bond markups violation. As noted above, the Hearing Officer dissents with regard to Mason's suspension.

[339] *Cf. Dist. Bus. Conduct Comm. v. Escalator Sec., Inc.*, No. C07930034, 1998 NASD Discip. LEXIS 21, at *1 (Feb. 19, 1998) (requiring restitution not paid to customers to be paid to FINRA as a fine).

B. Recordation of Time on Customer Orders

For recordkeeping violations, including violations of MSRB Rule G-8, the Guidelines recommend a fine of $1,000 to $10,000, increased to $10,000 to $100,000 in egregious cases. DLA's misconduct in this matter was egregious; it failed to record the time at which it received customer municipal bond orders in approximately 2,307 instances from April to June 2005. This misconduct occurred *after* a FINRA warning. Specifically, following a 2004 routine examination, DLA received a Letter of Caution from FINRA for its failure to comply with MSRB Rule G-8.[340] The firm's WSPs in effect at the time had no provision addressing this recording requirement.[341] Moreover, DLA has not acknowledged this violation. The Hearing Panel determined that the appropriate remedial sanction for this violation is a $25,000 fine.

C. Supervision and Written Supervisory Procedures

For the separate failures to supervise, in violation of MSRB Rule G-27 and NASD Conduct Rule 3010(a), the Guidelines recommend a fine of $5,000 to $50,000.[342] The Guidelines set forth the following considerations when determining the appropriate sanction for a failure to supervise: (1) the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls, (2) whether respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny; and (3) the nature, extent, size and character of the underlying misconduct.[343]

---

[340] CX-46, at 5.

[341] CX-7.

[342] *Guidelines*, at 103.

[343] *Id.*

The Hearing Panel found no evidence of any effective supervisory controls for DLA's municipal bond and CMO pricing. At the outset, DLA's supervisory structure was deficient in that it designated Mason as the supervisor for the Trading Department. Because Mason was also responsible for setting and reviewing the municipal bond and CMO prices, the supervisory structure amounted to self-supervision for Mason and the Trading Department. Additionally, Mason was compensated based on the trading profit of the Trading Department.[344]

Furthermore, even utilizing its ineffective system, DLA did virtually nothing to oversee Mason's supervision of municipal bond and CMO pricing. As noted above, Akerman, DLA's Director of Compliance and CCO, did not ever recall advising Mason that a price he set was too high.[345] In fact, Mason testified that no one at DLA ever told him that he was pricing municipal bonds and CMOs unfairly or improperly.[346]

While DLA's Compliance Department had a supervisory role with respect to the municipal bond and CMO transactions, it did not review *any* transactions in which the markups were less than 5% above the market price, which constituted many of violative trades in this matter. And, its review of transactions with markups greater than 5% consisted of ineffective spot-checks. DLA's failure to review any municipal bond and CMO pricing with markup below 5% was appalling, especially in light of the well-established guidance from regulators as well as case law that clearly stated that markups below 5% may be unfair and unreasonable. Further, by failing to focus on any markups below 5%, it tacitly endorsed Mason's pricing practices.

---

[344] Tr. 627-28.

[345] Tr. 550-51, 566-67.

[346] Tr. 2923-24.

DLA ignored "red flag" warnings that should have resulted in additional supervisory scrutiny. The most blatant red flag was the publically-available MSRB data that demonstrated Respondents' excessive markups. On a daily basis, DLA, through Mason, ignored the prices at which other customers purchased the exact same municipal bond. DLA also ignored the warning from FINRA. As discussed above, after DLA's 2004 routine exam, it received a letter of caution regarding its excessive markups. Despite the warning, DLA did not alter its supervisory practices.

Lastly, the underlying misconduct facilitated by the DLA's lack of supervision was egregious and pervasive, resulting in a pattern of unfair pricing in both municipal bond and CMO transactions that caused harm to retail customers in connection with the approximately 3,268 transactions at issue.

The evidence supports a fine for DLA exceeding the maximum called for under the Guidelines. The Hearing Panel determined that the appropriate remedial sanction for DLA is a total fine of $300,000 for its supervisory violations. For DLA's violation of MSRB Rule G-27, DLA is (1) fined $150,000, (2) required to revise its procedures to ensure that they are reasonably designed to comply with the requirements of MSRB Rule G-30, including but not limited to the deficiencies found in this proceeding in connection with the excessive municipal bond markups, and (3) required to retain an independent consultant with experience in designing and evaluating broker-dealer procedures, who shall be not unacceptable to Enforcement, to review and approve DLA's revised procedures as being reasonably designed to achieve compliance with the requirements of MSRB Rules G-30 and G-8. For DLA's violation of NASD Conduct Rules 3010(a) and 2110, DLA is also (1) fined $150,000, (2) required to revise its procedures to ensure that

they are reasonably designed to comply with the requirements of NASD Conduct Rule 2440 and IM-2440-1, including but not limited to the deficiencies found in this proceeding in connection with the excessive CMO markups, and (3) required to retain an independent consultant with experience in designing and evaluating broker-dealer procedures, who shall be not unacceptable to Enforcement, to review and approve DLA's revised procedures as being reasonably designed to achieve compliance with the requirements of NASD Conduct Rule 2440 and IM-2440-1.[347]

VI. ORDER

Based on careful consideration of all the evidence, the Hearing Panel imposes the following sanctions:[348]

A. First Cause of Action: DLA's and Mason's Unfair Municipal Bond Markups

1. For willfully charging excessive municipal bond markups in violation of MSRB Rules G-30 and G-17, DLA is fined $1 million. DLA is also ordered to pay restitution to the customers associated with the Identified Municipal Bond Trades specified in Schedule A to this decision, in the total amount of $765,345.28,[349] plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from the date of the municipal bond customer sale until the date that restitution is paid. Each customer shall be repaid the amount shown in the column labeled "Excess Markup" on Schedule A, plus interest. DLA is ordered to pay the restitution within 60 days of the effective date of this Decision. DLA is required to provide to

[347] Respondents may use the same consultant that they engage for the review of the municipal bond procedures provided the consultant has the necessary expertise in CMOs.

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

[349] CX-5. This restitution amount reflects the removal of the trades identified in footnote 8.

Enforcement proof of payment for each Identified Municipal Bond trade; if DLA cannot locate a customer, DLA must provide proof that it has made a bona fide attempt to locate the customer. Any amount of restitution not paid to customers shall be paid to FINRA in the form of a fine. The Hearing Panel eliminates the interest requirement on any sums paid to FINRA as a fine.

2. For willfully charging excessive municipal bond markups in violation of MSRB Rules G-30 and G-17, Mason is fined $100,000 and suspended for 6 months from associating with any member firm in any capacity.

B. Second Cause of Action: DLA's Failure to Record Time on Municipal Bond Order Tickets

For willfully failing to record the time of receipt on municipal bond customer order tickets, in violation of MSRB Rule G-8, DLA is fined $25,000.

C. Third Cause of Action: DLA's Inadequate Supervisory Systems and Procedures for Municipal Bonds

For willfully failing to supervise municipal bond pricing and establish and maintain adequate procedures to (1) monitor the fairness of pricing for municipal bonds, and (2) ensure that it recorded the time at which its customers placed municipal bond orders, in violation of MSRB Rule G-27, DLA is (1) fined $150,000, (2) required to revise its procedures to ensure that they are reasonably designed to comply with the requirements of MSRB Rules G-30 and G-8, including but not limited to the deficiencies found in this proceeding in connection with the excessive municipal bond markups, and (3) required to retain an independent consultant with experience in designing and evaluating broker-dealer procedures, who shall be not unacceptable to Enforcement, to review and approve DLA's revised procedures as being reasonably designed to achieve compliance with the requirements of MSRB Rules G-30 and G-8.

D. Fourth Cause of Action: Mason's Inadequate Supervisory Systems and Procedures for Municipal Bonds

The Fourth Cause of Action is dismissed.

E. Fifth Cause of Action: DLA's and Mason's Unfair CMO Markups

1. For charging excessive CMO markups in violation of NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110, DLA is fined $1 million. DLA is also ordered to pay restitution to the customers associated with the Identified CMO Trades specified in Schedule B to this decision, in the total amount of $692,731.24, plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from the date of CMO customer sale until the date that restitution is paid. Each customer shall be repaid the amount shown in the column labeled "Excess Markup" on Schedule B, plus interest. DLA is ordered to pay the restitution within 60 days of the effective date of this Decision. DLA is required to provide to Enforcement proof of payment for each Identified CMO trade; if DLA cannot locate a customer, DLA must provide proof that it has made a bona fide attempt to locate the customer. Any amount of restitution not paid to customers shall be paid to FINRA in the form of a fine. The Hearing Panel eliminates the interest requirement on any sums paid to FINRA as a fine.

2. For charging excessive CMO markups in violation of NASD Conduct Rule 2440 and IM-2440-1, and NASD Conduct Rule 2110, Mason is fined $100,000 and suspended for 6 months from associating with any member firm in any capacity. This suspension shall run concurrently with Mason's suspension in the First Cause of Action.

F. Sixth Cause of Action: DLA's and Mason's Inadequate Supervisory Systems and Procedures for CMOs

For failing to supervise CMO pricing and establish adequate procedures to monitor the fairness of prices for CMOs, in violation of NASD Conduct Rules 3010(a) and 2110, DLA is (1) fined $150,000, (2) required to revise its procedures to ensure that they are reasonably designed to comply with the requirements of NASD Conduct Rule 2440 and IM-2440-1, including but not limited to the deficiencies found in this proceeding in connection with the excessive CMO markups, and (3) required to retain an independent consultant with experience in designing and evaluating broker-dealer procedures, who shall be not unacceptable to Enforcement, to review and approve DLA's revised procedures as being reasonably designed to achieve compliance with the requirements of NASD Conduct Rule 2440 and IM-2440-1. The Sixth Cause of Action is dismissed with respect to Respondent Mason.

In addition, the Respondents, jointly and severally, are ordered to pay the costs of this proceeding in the total amount of $23,232.80, which include an administrative fee of $750 and hearing transcript costs of $22,482.80.

These sanctions shall become effective on a date set by FINRA, but not earlier than 30 days after this Decision becomes the final disciplinary action of FINRA; except, if this Decision becomes the final disciplinary action of FINRA, the suspension of Mason shall commence with the opening of business on June 4, 2012, and end at the close of business on December 3, 2012.

_____

Maureen A. Delaney
Hearing Officer
For the Extended Hearing Panel

DISSENT

Hearing Officer Delaney, dissenting, in part:

I respectfully dissent from the sanction imposed on Respondent Mason as I would impose a lengthier suspension for his markup violations. I join in the remainder of the decision.

Here, the evidence supports a sanction for Mason at the higher end of the Guidelines. DLA is a large firm, employing approximately 350 registered representatives. Mason played an important role at DLA. He was (and still is) an Executive Vice-President and Head Trader, who reported directly to David Lerner.[350] As the Head Trader, Mason determined which municipal bonds and CMOs to purchase.[351] He then set the prices, or was involved in setting the prices, that customers would pay to purchase those municipal bonds and CMOs.[352] Mason was responsible for everything in the Trading Department, including its profit and loss.[353] DLA compensated Mason based on the trading profit of the Trading Department.[354]

Mason has held the Head Trader position since 1993.[355] Mason testified that he knew the MSRB Rule G-30 and NASD Rule 2440 factors applied to the retail pricing, and it was his responsibility to comply with them.[356] That said, he could not explain how much weight he gave to any particular factor when pricing the municipal bonds and

[350] Tr. 793; CX-7, at 20; RX-47, at 12; CX-8, at 11.

[351] Tr. 606.

[352] Tr. 604-06, 609-10.

[353] Tr. 604-05.

[354] Tr. 627-28.

[355] Tr. 604.

[356] Tr. 641-42.

CMOs.[357] Mason also refused to acknowledge that the DLA's WSPs contained the incorrect factors for pricing CMOs.[358]

Regarding municipal bond pricing, Mason testified that yield to the customer was the most important factor in determining municipal bond prices.[359] Yet, DLA's customers received consistently below market yields. Mason used MSRB data to make sure he purchased municipal bonds at a good price.[360] Conversely, in pricing municipal bonds for DLA's customers, Mason did not consider the prices other dealers charged customers for the same bonds at the same time, or the yields received by such customers, as reported to the MSRB and made publicly available.[361] He ignored this information even though it was on the same screen and intermingled with the interdealer prices.[362] He also failed to make any attempt to determine the markups charged by other firms, either through discussions with other dealers or through review of MSRB data.[363]

Regarding CMOs, Mason acknowledged that average life was an important factor,[364] but his markups did not demonstrate a variation based on average life. While he wanted to pay the lowest possible price for the CMOs he purchased, which he accomplished by checking prices offered from other dealers,[365] Mason failed to ensure that DLA's customers received a fair price.

---

[357] Tr. 651, 704, 750, 765.

[358] Tr. 644-45.

[359] Tr. 661, 2413-14.

[360] Tr. 669, 686, 696.

[361] Tr. 671, 676-77, 686-87, 696.

[362] Tr. 686-87.

[363] Tr. 2853-59.

[364] Tr. 738.

[365] Tr. 615.

Mason's municipal bond and CMO pricng did not vary depending on the particular characteristics of the transactions such as size and amount. Instead, his markups reflected a pattern – generally a 4% or greater markup.

Mason lacked credibility. He testified that he factored in DLA's services when pricing the municipal bonds and CMOs;[366] however, he had no recollection of mentioning this factor during his investigative testimony.[367] Further, at the hearing, Mason admitted that he only knew of *some* of DLA's services.[368] He also had no basis for comparing DLA's services to other brokers because he was unaware of the services they provided.[369] Mason testified that he factored in DLA's expenses when pricing the municipal bonds and CMOs, but he failed to identify expenses as a factor in his Wells response.[370] Mason also testified that he considered mutual fund loads as a factor when pricing his municipal bonds and CMOs; however, he never identified mutual fund loads as a factor in his Wells response and had no recollection this factor in his investigative testimony.[371]

With regard to municipal bond pricing, Mason testified at the hearing that he relied on the 1981 case as a factor; however, he neglected to mention this in his prior investigative testimony and his Wells response.[372] Interestingly, while Mason claimed to have relied on this case, he admitted that he never read it or reviewed the markup schedule attached to the case.[373] Mason argued that the 1981 case set a standard,

---

[366] Tr. 694, 745.

[367] Tr. 694-95, 731-32.

[368] Tr. 698-99.

[369] Tr. 698, 702-03.

[370] *Compare* Tr. 697, 703, 717, 745 *with* CX-18.

[371] *Compare* Tr. 715-16, 750-52 *with* CX-18 and Tr. 733.

[372] *Compare* Tr. 650-53 *with* CX-18 and Tr. 667.

[373] Tr. 648, 665-66.

permitting him to markup his bonds by 40 basis points.[374] Yet, at the hearing, he refused to agree that a loss of 40 basis points on a bond that is yielding 8-9% is very different than a loss of 40 basis points on a bond that is yielding 4-5%.[375] Mason also testified that when pricing municipal bonds he would look at the price at which *similar* bonds traded; however, he would not look at what customers paid for the exact same bond (i.e., the MSRB data).[376]

For his CMO pricing, at the hearing, Mason claimed that DLA was a market maker and that he considered DLA's market maker status when pricing the CMOs.[377] However, he never mentioned DLA's market maker status in his Wells response.[378]

As the Head Trader, Mason was required to ensure that these markup violations did not occur. While Mason stated in his Answer that he attended numerous continuing education programs, conferences, and panels organized by FINRA on the subject of fair pricing and markups in the fixed income sphere, he ignored the regulatory requirements for fair pricing. The Hearing Officer finds that given (1) the manner in which Mason priced the municipal bonds and CMOs, (2) the pattern exhibited, (3) the amount of the markups and resulting customer harm, (4) the duration of the misconduct, and (5) Mason's lack of credibility, Mason's misconduct was intentional, or at a minimum extremely reckless.

While the Hearing Panel did not find Mason liable for the supervisory violations because he is liable as a primary violator, Mason had extensive supervisory

[374] Tr. 655-56.

[375] Tr. 656, 663-65.

[376] Tr. 671, 677, 687, 696.

[377] Tr. 761-65.

[378] CX-18.

responsibilities at DLA. The SEC recently emphasized that "[p]roper supervision is the touchstone to ensuring that broker-dealer operations comply with the securities laws and NASD rules" and "is a critical component to ensuring investor protection."[379] Mason has been the "designated supervisor" for the Trading Desk since November 1992.[380] He was responsible for supervising and training the traders.[381] David Lerner, the president of DLA, also relied on Mason to work with its investment counselors; Mason would regularly address them at their weekly meetings.[382]

He has been registered with FINRA as a Municipal Securities Principal since 1990, and a General Securities Principal since 1993.[383] "[T]he registration requirements are intended to ensure that principals 'maintain the requisite levels of knowledge and competence.'"[384] As a registered principal and the designated principal for the Trading Department in charge of teaching other traders on the proper pricing methods, Mason had an obligation to know the requirements and ensure that he was properly pricing the municipal bonds and CMOs. The SEC has stressed that a Series 24 principal registration comes with certain important responsibilities.

> NASD's registration requirement "provides an important safeguard in protecting public investors," and "strict adherence" to that requirement is "essential" because it "serves a significant purpose in the policing of the securities markets" and in the protection of the public interest…." As we also have observed, the "registered principal is the person at the broker-

[379] *Dennis S. Kaminski*, Exchange Act Rel. No. 65347, 2011 SEC LEXIS 3225, at *35 (Sept. 16, 2011) (citations omitted).

[380] CX-7, CX-8.

[381] CX-7; Tr. 604, 610.

[382] Tr. 2950.

[383] Compl. ¶ 3; Answer at 8, ¶ 3; CX-10.

[384] *Hans N. Beerbaum*, Exchange Act Rel. No. 55731, 2007 SEC LEXIS 971, at *14 n.17 (May 9, 2007).

> dealer to whom the NASD looks to ensure compliance with regulatory requirements."[385]

Given Mason's principal registration and his supervisory role at DLA, he cannot credibly claim that his pricing complied with FINRA's and MSRB's regulatory requirements.

"It is especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention."[386] As Head Trader and an Executive Vice-President at DLA, Mason was in a position of authority. The customer prices on the publically available MSRB data should have been a "red flag" for Mason, signaling that he was not charging a fair price to DLA's customers. "The duty of supervision includes the responsibility to *investigate 'red flags'* that suggest that misconduct may be occurring and to *act* upon the results of such investigation."[387] He ignored the red flags for 2 ½ years and refused to alter his unfair pricing.

All of the aggravating factors discussed in the Sanctions section are equally applicable to Mason. Accordingly, I conclude that Mason was, at a minimum, extremely reckless in pricing the municipal bonds and CMOs. He ignored market data that clearly demonstrated the extensive disparity between DLA's pricing and that of other firms. No excuse can justify this conduct. Unlike the majority, I cannot agree that Mason's misconduct warrants such a minor suspension. Mason is an experienced securities professional. Plus, as a registered general securities principal and municipal principal, he should have been a watchdog for potential securities violations in the Trading Department. Instead, Mason charged unfair prices on thousands of municipal bonds and

---

[385] *Id.* at *14.

[386] *Kaminski*, 2011 SEC LEXIS 3225, at *25-26.

[387] *Id.* at *25 (quoting *Michael T. Studer*, 57 S.E.C. 1011, 1023-24 (2004)) (emphasis added).

CMOs, resulting in nearly $1.5 million in customer harm. Thus, I would suspend Mason from associating with any member firm in any capacity for 18 months.

Copies to: David Lerner Associates, Inc. (*by overnight courier and first-class mail*)
William Mason (*by overnight courier and first-class mail*)
Paul J. Bazil, Esq. (*via electronic and first-class mail*)
Anthony W. Djinis, Esq. (*via electronic and first-class mail*)
Michael G. Shannon, Esq. (*via electronic and first-class mail*)
Jeffrey Pariser, Esq. (*via electronic and first-class mail*)
Matthew D. Meisner, Esq. (*via electronic mail*)
David R. Sonnenberg, Esq. (*via electronic mail*)