FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant v. BROOKSTONE SECURITIES, INC. (CRD No. 13366), ANTONY LEE TURBEVILLE (CRD No. 1721014), CHRISTOPHER DEAN KLINE (CRD No. 2597293), and DAVID WILLIAM LOCY (CRD No. 4682865), Respondents.	Disciplinary Proceeding No. 2007011413501 Hearing Officer – RSH **EXTENDED HEARING PANEL DECISION** May 31, 2012

For violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Rules 2120 and 2110, by making fraudulent misrepresentations and omissions of material fact in selling complex, esoteric, and risky tranches of collateralized mortgage obligations ("CMOs") to unsophisticated, elderly, and retired investors, Brookstone was censured and fined $500,000, and Turbeville and Kline were barred from associating in any capacity with any FINRA-regulated firm. The Second Cause of Action, which alleged, in the alternative, that Brookstone, Turbeville, and Kline acted negligently, was subsumed by the fraud charge. For violating Rules 2310(a) and 2110 by making unsuitable recommendations of CMOs, Brookstone was fined $300,000, and Turbeville and Kline were barred from associating in any capacity with any FINRA-regulated firm. For violating Rules 2210(d)(1)(A) and 2210(d)(1)(B) by making misrepresentations, omitting material facts, and using misleading statements in letters to customers, Brookstone was fined $50,000. For violating Rules 2510(b) and 2110 by failing to review customer discretionary accounts, Brookstone was fined $50,000, and Locy

was barred from acting in any supervisory or principal capacity with any FINRA-regulated firm. For violating Rules 3010(b) and 2110 by failing to adequately supervise customers' CMO accounts and transactions, and by failing to safeguard customer information, Brookstone was fined $100,000, and Locy was barred from acting in any supervisory or principal capacity with any FINRA-regulated firm, suspended from associating with any FINRA-regulated firm in any capacity for two years, and fined $25,000. Brookstone also was ordered to pay restitution in the amount of $1,620,100 with $440,600 of that amount imposed jointly and severally with Turbeville, and the remaining $1,179,500 imposed jointly and severally with Kline. The Respondents were also ordered to pay the hearing costs, which were assessed jointly and severally.

Appearances

For the DEPARTMENT OF ENFORCEMENT: Karen E. Whitaker, Dallas, Texas, Andrew Favret, New Orleans, Louisiana, and Adam B. Walker, Kansas City, Missouri.

For RESPONDENTS: Liam O'Brien, Harry J. Delagrammatikas, and Francis M. Curran, of MCCORMICK & O'BRIEN LLP, New York, New York.

DECISION

I. PROCEDURAL HISTORY[1]

The investigation that led to the filing of the Complaint developed during a FINRA[2] routine examination of Brookstone Securities, Inc. ("Brookstone").[3] On December 30, 2009, the FINRA Department of Enforcement filed with the Office of Hearing Officers a six-cause Complaint that alleged misconduct by Respondents between July 2005 and July 2007 ("Relevant Period"). The First Cause of Action alleged that Respondents Brookstone, Turbeville, and Kline

[1] In this decision, "Tr." refers to the transcript of the hearing; "CX" to Enforcement's exhibits, and "RX" to Respondents' exhibits.

[2] As of July 30, 2007, NASD began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA include, where appropriate, NASD. On December 15, 2008, certain consolidated FINRA rules replaced parallel NASD rules. In that process, Rule 2110 was re-numbered to 2010, which is substantially identical to its predecessor. *See* Regulatory Notice No. 08-57, FINRA Notices to Members, 2008 FINRA LEXIS 50 (Oct. 2008). This decision refers to the NASD rules that were in effect, at the time of the Respondents' alleged misconduct and cited in the Complaint as the basis for the charges against them.

[3] Tr. 1117.

violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, as well as Rules 2120 and 2110, by making fraudulent misrepresentations and omissions of material fact in selling collateralized mortgage obligations ("CMOs") to unsophisticated, elderly, and retired investors. The Second Cause of Action alleged, in the alternative, that Brookstone, Turbeville, and Kline violated Rule 2110 by making negligent misrepresentations and omissions of material fact in the sales of CMOs. The Third Cause of Action alleged that Brookstone, Turbeville, and Kline violated Rules 2310(a) and 2110 by making unsuitable recommendations of CMOs. The Fourth Cause of Action alleged that Brookstone and Turbeville violated Rules 2210(d)(1)(A) and 2210(d)(1)(B) by making misrepresentations, omitting material facts, and using misleading statements in letters to customers who invested in CMOs through Brookstone. The Fifth Cause of Action alleged that Brookstone and Locy violated Rules 2510(b) and 2110 by failing to review customer discretionary accounts. The Sixth Cause of Action alleged that Respondents Brookstone, Turbeville, and Locy violated Rules 3010(b) and 2110 by failing to adequately supervise customers' CMO accounts and transactions, and by failing to safeguard customer information.

On February 22, 2010, the Respondents filed their Answer, which denied the allegations in the Complaint.

The hearing was held before an Extended Hearing Panel ("Hearing Panel") composed of the Hearing Officer and two former members of the District 9 Committee. The 16-day hearing was held June 13-17, 2011, in Boca Raton, Florida; and October 10, 2011, October 17-21, 2011, and February 13-17, 2012, in Washington, DC. Enforcement called nine witnesses—five Brookstone customers, the sons of two Brookstone customers, an expert, and a FINRA examiner. The Respondents called five witnesses—two experts and the three individual Respondents. The

Hearing Panel accepted into evidence 324 exhibits submitted by Enforcement and 185 exhibits submitted by Respondents.

Based upon a review of the entire record, the Extended Hearing Panel makes the following findings of fact and conclusions of law.

II. BACKGROUND

A. Respondents

1. Brookstone Securities, Inc.

Brookstone is currently, and was during all relevant times, a FINRA-registered broker-dealer. Brookstone purchased predecessor broker-dealer RISE, Inc. on July 14, 2005. RISE, Inc. had been a member of FINRA since April 8, 1983. Brookstone currently employs 198 registered personnel and operates 45 branch offices. Brookstone's disciplinary history includes the following:

- On September 27, 2011, FINRA issued an Order Accepting Offer of Settlement (No. 2009017275301) in which Brookstone was censured and fined $200,000 for willful violations of Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, NASD Rules 2110, 2120, 3010(a), and 3010(b), and FINRA Rules 2010 and 2020. Turbeville and Locy were each fined $10,000 and suspended from association with any FINRA member firm in any principal capacity for three months. The Respondents agreed to findings that the firm, acting through registered representatives, made misrepresentations and/or omissions of material fact, provided unwarranted price predictions to customers, made guarantees against loss to customers, failed to disclose certain risks to customers, made unsuitable investment recommendations, and exercised discretion in customer accounts without prior written authorization or acceptance of the accounts as discretionary by Brookstone. Additionally, Brookstone, acting through Turbeville, its chief executive officer, and Locy, its president, failed to reasonably supervise a registered representative, failed to follow up on red flags, and failed to establish, maintain and enforce supervisory procedures reasonably designed to achieve compliance with respect to the above-described violations.

- On August 8, 2011, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2009016158302) in which Brookstone was censured and fined $15,000 for violations of Article V, Sections 2 and 3 of FINRA's By-Laws, FINRA Rules 1122 and 2010, NASD Rule 3070 and IM 1000-1. The firm agreed to findings that it failed to update or timely update Forms U4 and U5 with required information, and provided inadequate information in connection with Rule 3070 filings.
- On May 23, 2011, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2009019837303) in which Brookstone was fined $25,000, jointly and severally, with Locy, for violations of NASD Rules 2110 and 3010 and FINRA Rule 2010. The respondents agreed to findings that the firm, acting through Locy, had no written supervisory procedures addressing due diligence requirements for third-party private placements, and had failed to conduct adequate due diligence of a third-party private placement offering before approving the offering for sale to firm customers.
- On April 30, 2010, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2008011675701) in which Brookstone was censured and fined $17,500 for

violations of SEC Rules 17a-3(a), 17a-3(a)(18), and 17a-4, 17a-4(b)(1); Article V, Section 2 of the FINRA By-Laws; and NASD Rules 2110, 3010(a)(7), 3070, 3110(d), and 6230. The firm agreed to findings that it had failed to ensure that all of its registered personnel participated in the firm's annual compliance meeting; failed to timely update a registered representative's Form U4 to disclose required information; failed to timely disclose two customer complaints; failed to report five quarterly statistical customer complaints; failed to create and maintain a record of customers complaints or, alternatively, failed to maintain a separate file that contained the complainant's information; failed to report transactions to TRACE; and failed to evidence the creation and maintenance of order tickets for sell transactions in corporate bond transactions.[4]

2. Antony Lee Turbeville

Turbeville entered the securities industry in July 1987, when he became registered with a FINRA member firm. He subsequently registered with 11 different member firms, including Kovack Securities, Inc. ("Kovack") from July 2000 to May 2002; GunnAllen Financial, Inc. ("GunnAllen") from May 2002 to April 2003; Archer Alexander Securities Corporation ("Archer Alexander") from April 2003 to April 2005; and Brookstone from April 2005 to the present. During the Relevant Period, Turbeville served as a general securities principal and a registered representative with Brookstone. He also served as Brookstone's chairman and chief executive officer, and owned at least 75% of the firm. Turbeville is also a registered investment advisor with, and an indirect owner of, Brookstone Investment Advisory Services. During his career in the securities industry, Turbeville obtained Series 6, 7, 24, and 63 securities licenses. His

[4] CX-1 at 3, 6, 20.

disciplinary history includes the September 27, 2011 action noted above (AWC No. 2009017275301).[5]

The Hearing Panel listened to and observed Turbeville testify for a full day. While he displayed an understanding of CMOs, the Hearing Panel did not believe his claims that he fully explained the strategy to his clients so that they understood all of the risks involved in trading CMOs, or the risks of trading on margin. His testimony that his customers' account forms accurately reflected their investment objectives was contradicted by each of his customer's testimony and sworn declarations. He showed no remorse for his customers' losses, and insisted that they understood the CMO strategy, despite their claims that they did not.

The Hearing Panel did not find Turbeville's testimony credible. The Hearing Panel found that his customers, who did not know one another, testified truthfully when they said they did not understand how CMOs worked, and that they had never understood how they worked. The Hearing Panel believed the customers when they testified that they had invested in the CMO strategy because they trusted Turbeville when he told them that their assets would be safe and would grow, whether interest rates went up or down. The marketing materials and the Financial Profile that Turbeville gave to one of his customers (Mr. MR) corroborated MR's and the other customers' testimony. In addition, the testimony of the three experts, two of whom were Respondents' experts, supported the Hearing Panel's conclusion that the CMOs at issue and the trading strategy proposed by Brookstone and Turbeville, were too complex for Turbeville's unsophisticated customers to understand.

[5] CX-1 at 6; CX-4 at 4-9, 16, 31.

3. Christopher Dean Kline

Kline entered the securities industry in February 1995, when he became registered with a FINRA member firm. He subsequently became registered with six different member firms. While working at Kovack from April 2001 to May 2002, Kline met Turbeville, and subsequently moved with Turbeville as he changed firms: GunnAllen from May 2002 to April 2003; Archer Alexander from April 2003 to April 2005; and Brookstone from April 2005 to the present. During the Relevant Period, Kline was registered as a general securities representative with Brookstone. During his career in the securities industry, Kline obtained Series 7 and 63 securities licenses. He has no prior disciplinary history.[6]

The Hearing Panel listened to and observed Kline testify for most of a day. The Hearing Panel did not believe his claims that he fully explained the strategy to his clients so that they understood all of the risks involved in trading CMOs, or the risks of trading on margin. His testimony that his customers' account forms accurately reflected their investment objectives was contradicted by his customers' testimony and sworn declarations. The testimony given by the three experts who testified supported the Hearing Panel's conclusion that the CMOs at issue and the trading strategy proposed by Kline were too complex for his unsophisticated customers to understand.

4. David William Locy

Locy entered the securities industry in June 2003, when he became associated with FINRA member firm Archer Alexander, where he met Turbeville and Kline.[7] He moved with Turbeville and Kline to Brookstone in June 2005. Turbeville hired Locy to be Brookstone's

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[6] CX-2.

[7] Tr. 2277.

chief compliance officer and he held that position during the Relevant Period.[8] He is currently Brookstone's chief financial officer and FINOP.[9] Locy is also a direct owner of Brookstone Investment Advisory Services. During his career in the securities industry, Locy obtained Series 4, 7, 24, 27, 53, and 63 securities licenses. His disciplinary history includes the May 23rd and the September 27th actions (AWC Nos. 2009019837303 and 2009017275301, respectively), noted above.[10]

Locy's claims that he properly supervised the CMO trading in Brookstone's customers' accounts were contradicted by the evidence presented at the hearing. Locy admitted numerous times that he had not reviewed each of the accounts, but rather had reviewed them randomly. He also admitted that he had not conducted specific reviews of discretionary and margin accounts. Although he claimed to have conducted some reviews, he had no documentary evidence of any such reviews, and he was impeached by his on-the-record interview ("OTR") testimony several times.[11] The Hearing Panel did not find his testimony to be credible.

B. Collateralized Mortgage Obligations

1. NASD Notice to Members 93-73 ("NTM 93-73")

NASD first issued guidance to member firms and registered representatives about recommending CMOs in NTM 93-73, which remains in effect. The Notice was issued during a time of turmoil in the CMO markets in 1993-94. As a result of rising interest rates, the CMO market collapsed. This collapse resulted in "very significant losses, especially in inverse

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[8] CX-1 at 5; Tr. 2266.

[9] CX-3 at 7; Tr. 2266.

[10] CX-3 at 1, 15.

[11] Tr. 2382-2394.

floaters."[12] Turbeville and Locy testified that they had never heard of NTM 93-73 until FINRA's investigation in this matter.[13] Kline testified that he was aware of NTM 93-73 before FINRA's investigation; however, he displayed no understanding of the Notice's contents.[14]

NTM 93-73 provides an overview of the various types of CMOs and states: "…investors have to know that CMOs are not the same as conventional debt securities or CDs and that time to maturity may vary as well as the amount of principal returned."[15] The Notice warns that "[i]n light of the complexity and the varying risk characteristics of CMOs…members must be conversant in all of the characteristics of CMOs to assess adequately the suitability of CMOs for their customers. Moreover, members must ensure that their customers understand the characteristics and risks associated with CMOs."[16] Further, NTM 93-73 notes that, "…certain tranches may be structured in such a way that, depending on interest rates and prepayments, investors are at substantial risk and may lose all or a substantial portion of their principal. The risks associated with these less predictable tranches may make them unsuitable for many retail investors. *Members must evaluate the suitability of such high-risk tranches for each individual investor based on the investor's sophistication and high-risk profile, and must ensure that the investor is aware of the risks and characteristics of the tranche*."[17]

[12] Tr. 798-801.

[13] Tr. 2155-2156, 2291.

[14] Tr. 2976.

[15] CX-360 at 2 (NTM 93-73), emphasis added.

[16] *Id*, at 1.

[17] *Id.* at 2.

a. Interest Only CMOs ("IOs")

NTM 93-73 states that, "IOs increase in value when interest rates rise and prepayment rates slow; consequently, they are often used to "hedge" portfolios against interest rate risk. IO investors should be mindful that if prepayment rates are high, they may actually receive less cash back than they initially invested. *Because of these risks, a member may sell IOs only to a sophisticated investor maintaining a high-risk profile. The member should make sure the investor is aware of the risks and characteristics of IOs*."[18]

b. Inverse Floater CMOs ("IFs")

NTM 93-73 states that, "Inverse floaters are structured to offset floating-rate tranches. Interest payments on IFs vary inversely with an index. Because IFs are more leveraged than other tranches, they have high price volatility as interest rates move. As the rate of the index drops, the interest rate on the IF rises at an accelerated pace. Conversely, rising rates cause an IF's interest payments to drop dramatically. At worst, rising rates will lower interest payments and extend return of principal beyond the anticipated average life. *As with other high-risk tranches, IFs are only suitable for sophisticated investors with a high-risk profile and the investor must be made aware of the risks and characteristics of IFs being purchased*.[19]

2. Expert Analyses of the CMO Trading in Brookstone Customer Accounts

The Hearing Panel heard approximately 15 hours of testimony from the parties' three well-qualified experts, as each of them explained, to panelists with many years of experience in the securities industry, how CMOs, IFs, and IOs operate, as well as how they were traded in the

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[18] *Id.* at 3.

[19] *Id*.

accounts at issue in this case.[20] Each expert also filed reports containing many pages of charts, graphs, and references.[21] The overwhelming weight of the experts' reports and testimony, coupled with testimony from Brookstone customers, led the Hearing Panel to conclude that the CMOs at issue in this case were so complex that it is inconceivable that the Respondents' customers, some of whom had no education beyond high school, could understand the securities and the numerous risks involved in trading them.

The Respondents called two experts who are both economic consultants and securities analysts—Robert MacLaverty, and Faten Sabry. Sabry, who has a Ph.D in economics, testified about CMOs and their operation, market conditions during the Relevant Period, and the representations contained in CMO sales literature that the Respondents gave to their customers. Sabry's descriptions generally comported with those in NTM 93-73. She did not analyze trading in the Brookstone customers' accounts, and did not give any opinions on suitability.

MacLaverty has many years of experience as an economic consultant and with trading complex securities for large institutional investors. Like Sabry, MacLaverty testified about CMOs, how they work, and market conditions during the Relevant Period. His explanations generally agreed with those in NTM 93-73. In addition, MacLaverty testified that in his opinion, the CMO strategy employed by the Respondents was suitable for the Brookstone customers, based on their investment objectives.

The Hearing Panel disregarded MacLaverty's opinion on suitability for two reasons. First, unlike Gifford Fong ("Fong"), Enforcement's expert, who analyzed all the trading in all of the Brookstone accounts at issue, MacLaverty, because of "budget and time constraints,"

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[20] Tr. 769-1022 (Fong), 3067-3290 (MacLaverty), 3308-3357 (Sabry).

[21] CX-353 (Fong Expert Report); RX-70 (MacLaverty Expert Report); RX-71 (Sabry Expert Report).

analyzed trading in only two of the accounts.[22] Further, he only analyzed trading for the securities for which he was able to obtain pricing information, and he didn't know what percentage of the total CMOs that was.[23] Second, MacLaverty's opinion on suitability was based on the assumption that the customers' account documents, which indicated "aggressive income" investment objectives and many years of experience, accurately reflected the customers' investment objectives, experience, and sophistication.[24] MacLaverty assumed that the customers fully understood the risks of the aggressive income strategy.[25] He also did not take into account the time horizons of the customers, who were between 61 and 91 years old. MacLaverty testified that he was not aware of the customers' written declarations and testimony about their objectives and experience, which the Hearing Panel found more accurately reflected the customers' actual investment objectives and experience.

For the reasons discussed below in the sections describing each customer, the Hearing Panel found that the account documents upon which MacLaverty based his suitability opinions do not accurately reflect the investment objectives, experience, financial sophistication, or retirement needs of the Brookstone customers. In contrast, Fong relied on the customers' declarations as well as other documentary information in forming his opinions.[26] The Hearing Panel found that Fong's analyses and opinions therefore were based on information that accurately reflected the customers' investment objectives of safety and preservation of capital,

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[22] RX-70; Tr. 3080.

[23] Tr. 3088, 3129.

[24] RX-70 at 5-6.

[25] MacLaverty Rebuttal Report at 3, 5.

[26] CX-353 at 33-34; Tr. 915, 939.

their limited experience and understanding of complex CMO products, their financial needs during retirement, and their limited time horizons.

Fong has been involved in the valuation of complex and illiquid securities for large institutions, including JP Morgan, Bank of New York, and the Federal Reserve Bank system, since 1974. He testified extensively about IFs and other CMOs, how they work, and market conditions during the Relevant Period. He conducted analyses of all of the trading in the accounts at issue in this case. Based on his knowledge, experience, and analyses of the accounts, he testified that the CMOs were not suitable for the Brookstone customers in this case.

After analyzing the Brookstone customers' CMO portfolios, Fong found that the portfolios consisted primarily of IFs along with some positions in IOs. Fong explained that an IF is a highly leveraged product. It is exposed to various risks such as: (1) Interest rate risk, which is the risk of price change due to changes in nominal interest rates; (2) Credit risk, which is the risk of price change due to a change in credit rating or probability of default; (3) Prepayment risk, which is the risk of price change due to unexpected changes in prepayment rates; and (4) Liquidity risk, which is the risk of price change due to a change in the liquidity of the security. When considering the risk of a portfolio, it is not adequate to focus on a single risk. Instead, each source of risk and its overall effect on the portfolio must be considered.[27] Fong found that the Respondents' disclosure documents did not adequately disclose these risks to their CMO customers.[28]

Fong described IFs as "very risky in general … if you look at the spectrum of risk of fixed income securities, inverse floaters are considered at the far end of riskiness. So by way of

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[27] CX-353 at 5, 11-12.

[28] Tr. 937-939.

context, the least risky would be a three-month treasury bill. You would then go to various types of securities, whether they be, say, five or ten-year treasuries or five or ten-year corporate bonds. Once you get beyond like, say, the ten-year treasury, then you'll basically run into risky securities like high-yield bonds, corporate bonds, but even beyond those types of securities, inverse floaters would be even more risky. So they're really at the far end of the risk spectrum."[29]

Fong identified "effective duration" as "the recognized and primary measure of interest rate risk which is the dominant, on average, the dominant risk of CMOs."[30] He explained effective duration as follows: "Inverse floaters are very risky because in general they have a very high effective duration, which means they have a very high sensitivity to interest rate change. It's not uncommon for inverse floaters to have durations which are in excess of 15, for example. So to put this in context, an effective duration of 15 is equivalent to a 15-year zero coupon treasury. To put this further in context, money market funds have a duration of about .25 or so.…[31] In another example, Fong explained the meaning of an effective duration of 41, which was the effective duration for the account of MR, one of the Brookstone customers. "The longest traditional treasury security is 30 years…that duration of that 30-year bond is closer to—and I don't have the exact number, but it's in the teens. In this case we're talking about a duration of 41 and that's equal to a zero coupon treasury with a maturity of 41 years."[32]

Fong calculated the average weighted duration in each of the Brookstone customers' accounts on several dates across the Relevant Period. These figures showed that Turbeville and Kline constructed CMO portfolios for their customers that were highly sensitive to changes in

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[29] Tr. 834-835.

[30] Tr. 803.

[31] Tr. 809-810.

[32] Tr. 1015-1016.

interest rates. As time went on, the riskiness increased until the customers' entire portfolios were exposed to a degree of risk that would only be appropriate for sophisticated institutional investors interested in speculation.[33] Moreover, the use of margin to invest in the CMO strategy nearly doubled the effective duration in the portfolios of Mr. and Mrs. MR, Ms. JG, Mrs. CP, and Mr. HP.[34] None of the Respondents or their expert witnesses challenged the accuracy of the effective-duration figures that Fong calculated.[35]

Fong explained that while the value of IFs moves inversely to changes in interest rates, the value of IOs moves in the same direction as changes in interest rates, thereby providing a means of hedging interest rate risk in a rising interest rate environment. Fong testified that from July 2005 to July 2006, interest rates, such as the one-month LIBOR and the prime rate (to which the IFs in the Brookstone accounts were pegged), increased and remained at a high level until September 2007. As a result, the value of the highly-leveraged IFs decreased. Fong found that the Brookstone portfolios contained very few or no IOs to offset the IF price declines. He concluded that "The ineffective risk mitigation due to a lack of risk control, and the further leverage from margin purchases in certain customer accounts resulted in large losses for customer portfolios. Furthermore, customers incurred high commission expenses resulting from high portfolio turnover."[36]

Fong testified that he saw no evidence that the Respondents tried to limit interest-rate risk (duration), whether by purchasing IOs or through some other means. The result of having

[33] CX-353 at 19-20; Tr. 1019.

[34] CX-353 at 18-19.

[35] Tr. 3255-3256 (R. MacLaverty: "I don't have any reason to believe that [Fong's] calculations are incorrect").

[36] CX-353 at 5.

customer portfolios consisting almost entirely of inverse floaters was that the customers' exposure to interest-rate risk was exceedingly high. [37]

3. The Respondents' CMO Strategy

During the Relevant Period, the Respondents implemented a CMO program whereby each month Brookstone purchased large blocks of CMOs, which ranged in value from approximately $97,000 to over $5 million, from Doug Green, a registered representative with FINRA member firm Crocker Securities.[38] Pursuant to his consulting agreement with Brookstone, Green identified CMOs for Turbeville and Locy to purchase for their customers.[39] According to the arrangement with Brookstone, Green and his unregistered assistant, Robert Utne, were given access to Brookstone customer account information, which they in turn used to make both firm-wide and account-specific recommendations for CMO purchases.[40] Each month, Brookstone, acting through Turbeville and Kline, bought at least one block of CMOs, which they then resold to customers according to the buying power in each customer's account. [41] Typically, Turbeville and Kline sold existing IF positions in customer accounts and replaced them with new IF positions. In many instances, bonds were sold at a discount, thereby causing customers to realize their losses and forfeit the principal guarantee, in order to purchase bonds that had higher coupons, but that were priced closer to par. The risks inherent in the Respondents' management of the accounts were exacerbated by the use of margin in four of the accounts.[42]

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[37] Tr. 821(G. Fong: "We saw no evidence of the use of duration in any of the materials we saw from Brookstone").

[38] CX-365.

[39] CX-306; Tr. 2159-2165, 2309, 2312-2313.

[40] CX-252 at 2; CX-256; CX-258; CX-260 at 8-14.

[41] CX-259, CX-260, CX-365; Tr. 1355-1357, 2323.

[42] CX-353; Tr. 1420-1422.

As short-term interest rates rose consistently from 2004 until 2007, the coupon payments from the customers' IFs fell sharply and stayed low. This had a direct, negative effect on the liquidity and pricing of the IFs. As a result, the customers' CMO portfolios dropped precipitously in value, and when Turbeville and Kline sold the poorly-performing bonds, they generally sold at steep discounts, thereby locking in the customers' losses. Regularly turning over their customers' holdings was part of the Respondents' "active management"; however, the strategy benefited Respondents at their customers' expense.

Although Respondents' active trading did little to reduce the risk of loss in the customers' accounts, it did serve as a source of income for Respondents. Between July 2005 and July 2007, Respondents executed purchase transactions for CMO bonds worth approximately $63,547,632, and executed sell transactions worth approximately $62,348,009. During the Relevant Period, Brookstone earned approximately $492,500 in commissions from the seven customers whose accounts are at issue in this case. During the same period, those customers lost approximately $1,620,100.[43]

C. Brookstone Customers

Turbeville and Kline began recommending the purchase of CMOs to each of the customers in this matter prior to becoming registered with Brookstone. Accordingly, Turbeville and Kline made all of the initial CMO sales to the customers while they were registered with other FINRA member firms, including Kovack, GunnAllen, and Archer Alexander. In 2005, Turbeville and Kline transferred their customers' accounts to Brookstone and continued executing discretionary CMO transactions in the accounts. The firm name was different, but Turbeville and Kline traded the customers' accounts in the same manner as they had before

[43] CX-357A, 358A, 359A, 360A, 362A, 363A, 364A.

coming to Brookstone. To update the customers' new account forms, they had an administrative assistant fill out the new forms using information contained on the customers' old account records, and sent the new pre-filled forms to the customers with arrow stickers indicating where the customers should sign.[44] By 2005, interest rates were increasing, and the negative effect on CMOs was evident to Turbeville and Kline. Nevertheless, they did not explain the changing conditions to their customers until after some of the customers began asking about losses in their accounts.[45]

The Hearing Panel found that all of the Brookstone customers[46] in this matter were unsophisticated investors who had always relied on brokers to assist them with their investment needs. When the customers met either Turbeville or Kline, they were all looking for safer alternatives to equity investments. Turbeville and Kline led the customers to believe that they had the answer—in the form of "government-guaranteed bonds" that preserved capital while at the same time generating 10% to 15% returns. Based on these representations and several others by Turbeville and Kline, the customers decided to transfer their retirement assets to Turbeville or Kline and allowed the brokers to execute CMO transactions on a discretionary basis in their accounts. Some customers also allowed Turbeville and Kline to trade CMOs on margin in their accounts.

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[44] Tr. 1202-1203.

[45] CX-315 and 318 (Kline Letters); CX-338 and 339 (Turbeville letters).

[46] Except for Douglas, about whom there was insufficient evidence.

None of the customers in this matter know each other; their only link is that they were all customers of the Respondents. Notwithstanding the fact that they were not acquainted with each other, the customers all tell similar stories regarding their dealings with Turbeville and Kline. The inadequacy of Turbeville's and Kline's risk disclosures to the customers regarding investing in CMOs is evident from the fact that the customers uniformly stated that they were led to believe that CMOs were safe, government-backed investments for their retirement funds.

1. Turbeville's Three Customers

a. Customer Mr. MR

Mr. MR, age 76 (and his wife, Mrs. MR, age 66), met Turbeville in 2001, when they attended a seminar hosted by Turbeville in Lakeland, Florida. The MRs learned about the seminar when they saw a flyer posted at a cafeteria where they were eating.[47] The full-color flyer, displaying a picture of Turbeville with a large American flag waving in the background, invited people to the "Senior Citizens Maximum Income and Asset Protection Seminar." The flyer stated that Turbeville would "explain the financial dilemmas which can threaten the financial peace of mind of senior citizens."[48] At the seminar, Turbeville talked about ways in which seniors could protect and grow their assets.[49] Among other securities, he discussed CMOs.[50] Turbeville handed out a brochure stating that "protecting assets from nursing homes is a specialty." Turbeville characterized his CMO investment strategy as a "government bond

[47] Tr. 427; 598-599.

[48] CX-335.

[49] Tr. 603-604.

[50] Tr. 433-434.

strategy." [51] Based on the seminar, the MRs made an appointment to meet Turbeville at his office in Lakeland.

At that time, MR had been retired for several years. Prior to his retirement, MR, whose highest level of education is high school, sold mobile homes. He had also owned car washes and convenience stores.[52] MR had very limited investment knowledge, and his investment experience consisted of investing in CDs, money-market funds, municipal bonds, and mutual funds through accounts at Merrill Lynch.[53] Prior to meeting Turbeville, MR had never invested in CMO bonds or purchased investments on margin.[54]

During the meeting with Turbeville, MR told Turbeville that he did not want high-risk investments, and that he could not afford to lose any of his retirement money at his age.[55] Following the meeting, Turbeville prepared a written *Financial Profile* for MR.[56] In the *Profile,* Turbeville recorded that MR's annual income was $173,004, all of which derived from social security payments, investments in mutual funds, rental properties, and his interest in a carwash and convenience store being run by his son.[57] Turbeville also calculated that MR's net worth was $2,662,767.[58] The *Profile* indicated that on a "Financial Concerns" scale of 0 to 9, MR had ranked "Liquidity" and "Family" (defined in the *Profile* as "providing for his family in the event

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[51] CX-335.

[52] Tr. 423-425.

[53] CX-32.

[54] CX-32; Tr. 459-460.

[55] CX-32; Tr. 474, 479-480.

[56] CX-337.

[57] *Id.* at 7.

[58] *Id*. at 9.

of his death") at 9, and "Safety" (defined as "guaranteed savings; that you will not lose any of the money you set aside") as 8. MR had ranked "Income" as the last of his concerns, at 4.[59]

In the *Profile*, Turbeville told MR that "preservation of your principal cannot be reasonably assured in your current equity investments."[60] Turbeville also advised MR that "[f]or those assets that you wish to maintain principal with a high degree of predictability and wish to obtain above average returns, the Government Agency Bond strategy discussed in our previous meeting is in my opinion, the single best option available for your situation." According to Turbeville, the strategy, utilizing CMOs, which Turbeville described as "government agency bonds," would provide "[a] hedged portfolio which will provide stability of principal," "[a] return of 10% with a high degree of predictability," "liquidity," and "no commissions, ticket charges or penalties to you." Turbeville also stated that if MR would "allow the use of margin, [he could] reasonably expect a 15% annual return."[61] In a section of the *Profile* entitled "Suggested Action Plan," Turbeville recommended that MR move funds that were invested in money market funds to the "government agency bond strategy." Turbeville further recommended that MR "[u]tilize margin in the bond account to enhance returns."[62] In the section of the *Profile* entitled "Conclusion," Turbeville stated "[b]y following the above recommendations, you will put safety values in place to help preserve the income-producing power of the principal invested in equities … obtain returns substantially above average in a stable government agency bond strategy, maintain liquidity, and avoid commissions."[63] There were no disclosures in the *Profile*

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[59] CX-337 at 3.

[60] Id. at 11.

[61] *Id*. at 12-13.

[62] *Id*. at 13.

[63] *Id*. at 14.

regarding the substantial risks associated with investing in the recommended "government agency bond strategy," or the magnified risk associated with investing in CMOs on margin.

Turbeville's representations during the initial meeting and his written representations in the *Financial Profile* convinced MR that if he invested his retirement funds in CMO bonds as recommended, his funds would be safe and backed by the federal government. Significantly, Turbeville also told MR that because of the way Turbeville would be structuring MR's portfolio of CMOs, he would make money whether interest rates went up or down.[64] Based on Turbeville's representations, MR decided to implement Turbeville's investment recommendations and subsequently opened accounts with Turbeville while he was associated with Kovack. MR gave Turbeville written discretionary authority to trade his accounts, and authorized the use of margin.[65] As Turbeville moved from firm to firm, MR followed. In connection with each move, Turbeville provided MR with pre-populated new account documentation for his signature. MR would sign the paperwork as requested, and Turbeville continued the same trading strategy that he had been pursuing at each previous firm.[66]

In 2005, when Turbeville moved to Brookstone, MR opened two accounts at the firm—a joint account with his wife and a living trust account. As he had done previously, Turbeville provided MR with pre-populated new account documentation. The Brookstone new account forms showed a*ggressive income* as MR's most important investment objective and *aggressive* as his investment style (this term is used by Brookstone in the same manner as the term "risk tolerance"). When he opened his accounts at Brookstone, MR's net worth (excluding primary

[64] Tr. 452, 456.

[65] CX-31.

[66] Tr. 479-481, 623-625; CX-32.

residence) was approximately $1.4 million, and his annual income was approximately $100,000 in pension and other income. [67]

As interest rates rose from 2005 to 2007, the CMOs in MR's account declined in value. MR's losses were compounded by the fact that Turbeville had utilized significant margin in his accounts. As a direct result of implementing the investment recommendations made by Brookstone and Turbeville, MR lost approximately $414,800 of his retirement savings.[68]

The Hearing Panel, after listening to and observing Mr. MR's testimony, found him to be honest and truthful in his description of his dealings with Turbeville. He testified credibly that he had never had an "aggressive income" investment objective. He was most interested in preserving the assets he had, because at his age he was "too old to start over."[69] MR stood by his sworn declaration of events, and MR's testimony and declaration were corroborated by his wife, and Turbeville's other customers. The Hearing Panel found that MR did not have any meaningful understanding of CMOs or the risks entailed by Turbeville's trading strategy.

b. Customer Ms. BC

Ms. BC, age 68, retired from her employment as a payroll clerk with a supermarket chain in May 2004. Because her retirement funds proved to be insufficient, Ms. BC returned to work from 2005 to 2010 as a teaching assistant earning approximately $18,000 per year. Ms. BC retired a second time in February 2010.[70] When she met Turbeville, Ms. BC had very limited investment knowledge. Her investment experience consisted of investing in her employer's

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[67] CX-357A; CX-32.

[68] CX-357A.

[69] Tr. 433.

[70] Tr. 36-37.

stock (which was publicly traded) through her 401(k) account.[71] She also had an account at Wachovia through which she sold shares of stock that she had received in connection with her employment. She used the proceeds of the stock sales to invest in mutual funds and money market funds through Wachovia. Prior to meeting Turbeville, Ms. BC had never invested in CMO bonds. [72] Her total net worth and liquid net worth (excluding primary residence) was approximately $280,000 (consisting of $237,000 in a 401(k) account that was rolled over to an IRA after her retirement, and approximately $43,000 in her Wachovia securities account). Ms. BC's investment objectives were to generate income and to grow her retirement funds to help offset inflation.[73]

Ms. BC was referred to Turbeville by her brother, a truck driver, who worked with Turbeville's brother, who was also a truck driver.[74] During her initial meeting with Turbeville, Ms. BC informed him that she was interested in transferring from Wachovia because her accounts had been losing money. She also told him that she would transfer her 401(k) upon her retirement. Finally, Ms. BC told Turbeville that she could not afford to lose any of her retirement funds. Turbeville told Ms. BC that he could meet her investment objectives by investing the funds from her Wachovia account in growth investments, and by investing all of the funds in her 401(k) account in CMO bonds. As he had with MR, Turbeville told Ms. BC that his "government bond strategy" would provide income whether interest rates rose or fell, and that because the bonds were "government guaranteed," they would be guaranteed to return her principal. He told Ms. BC that although he could not guarantee her returns, he was sure she

[71] CX-17 at 6-7.

[72] Tr. 42.

[73] CX-17 at 6.

[74] Tr. 37-38.

could make 10% on her investment, and that her gain would probably be 15% to 20%. Turbeville did not disclose any risks associated with his recommended investment strategy.[75]

Based on Turbeville's representations, Ms. BC agreed to invest with him.[76] She transferred her Wachovia account to him in November 2003. Turbeville invested those funds in individual stocks. When she retired in July 2004, Ms. BC transferred her entire 401(k) account to Turbeville. He invested those funds in CMOs. Ms. BC noticed that the value of her account was steadily decreasing in late 2004 and early 2005. When she called Turbeville about this, he said that there was no way she could lose money as long as she was patient and gave the bonds time to mature.[77]

In February 2006, Turbeville sent Ms. BC updated new account documents to sign in connection with the transfer of her account to Brookstone. The *Customer Risk Assessment* form arrived already marked for her with a *moderate* risk tolerance. Ms. BC scratched out *moderate* and checked *stable/income*. On the *Financial Information* form, Ms. BC's income and investment experience were overstated, so she made changes to those items as well. She also changed her *Investment Style* from *moderate* to *conservative*. The form listed Ms. BC's investment objectives, in order of importance, as: growth, speculation, aggressive income, income, and preservation of capital. Ms. BC changed her investment objectives to the following order: income, preservation of capital, growth, aggressive income, and speculation.[78] Ms. BC

[75] CX-17 at 6, Tr. 60-61.

[76] CX-17 at 7

[77] CX-17 at 7.

[78] CX-14 at 7-10.

sent the revised paperwork back to Turbeville unsigned, believing that his office would make her requested changes and give her new documents to sign.[79]

In May 2006, Ms. BC met with Turbeville at his office to review and sign the paperwork. During her review, Ms. BC noticed that her primary investment objective was marked "aggressive income." She asked Turbeville about this and told him that she did not want to invest in anything that was aggressive. Turbeville told her that aggressive income did not mean risky investments. He told Ms. BC that she should not be concerned.[80]

In April 2006, Turbeville sent Ms. BC a letter that stated, "We are now, for the most part, in a buy and hold pattern."[81] Ms. BC received another letter from Turbeville in May 2006, recommending that she continue to hold her CMO bonds. The letter also stated that the average life of the bonds in her account is 3-5 years.[82] Ms. BC did not understand what "average life" meant, and she became concerned when she noticed that Turbeville was buying bonds with maturity dates beyond the year 2030.[83] In August 2007, Ms. BC informed Turbeville that she wanted to close her account. During the Relevant Period, she lost approximately $22,100 from her CMO investments.[84]

The Hearing Panel observed Ms. BC's testimony and found her to be credible. In addition, her testimony was consistent with the testimony and declaration of the other Brookstone customers.

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[79] Tr. 62.

[80] CX-17 at 7.

[81] CX-14 at 11-12.

[82] CX-16 at 2.

[83] Tr. 93, 96-97.

[84] CX-359A.

c. Customer Mrs. BB

Mrs. BB, an 88-year-old retired widow, met Turbeville when she attended one of his free lunch seminars in the late 1990s. Before her retirement, Mrs. BB had worked as a registered nurse, including working for the United States military. Mrs. BB had limited investment knowledge, and her investment experience included investing in blue-chip stocks and equity and bond mutual funds through an IRA and a trust account at Merrill Lynch. Mrs. BB's total net worth (excluding primary residence) was approximately $140,000 (including approximately $20,000 in savings; an IRA valued at approximately $50,000 and other assets worth approximately $70,000); liquid net worth of approximately $140,000; and annual income of approximately $14,400 (Social Security).[85]

Following the seminar, Mrs. BB agreed to meet with Turbeville individually to discuss her investment needs. She told him that her investment objective was to generate income for her required minimum distribution from her 401(k) plan, and to hopefully still achieve some growth. Although she hoped to earn a better return than a bank savings account, Mrs. BB's risk tolerance was very low because of her age and financial situation. She did not want to invest in aggressive investments or risk losing her retirement savings.[86]

Based on Turbeville's representations made during the meeting, Mrs. BB agreed to transfer her accounts to Brookstone. During the summer of 2007, when Mrs. BB realized that her accounts had fallen in value by several thousand dollars in one month, she became very concerned because she thought her investments would be safe—she did not expect any volatility.

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[85] CX-23.

[86] *Id.*

Mrs. BB subsequently decided to transfer her account to a new broker. She suffered losses of $3,700 during the Relevant Period in connection with her CMO investments.[87]

Mrs. BB came to the hearing and tried to give testimony to the Hearing Panel. It quickly became clear that her memory of events was foggy and confused, and she was unable to provide any meaningful testimony at the hearing. Brooks Brown, the FINRA examiner who drafted Mrs. BB's Declaration, testified that she was lucid and not confused when he spoke to her, and that her Declaration accurately stated what she had told him. Mrs. BB's Declaration was corroborated in so many respects by Turbeville's other customers, and with testimony and declarations about how Brookstone's other CMO customers were treated, that the Hearing Panel found it reliable.

2. Kline's Five Customers

Because of death, incapacity, and in one case, fear, only one of Kline's customers, Mr. SB, testified. The Hearing Panel found that Mr. SB testified truthfully when he said he did not understand how CMOs worked, but had invested in the CMO strategy because he believed and trusted Kline. Like Turbeville's customers, SB testified that Kline told SB that his assets would be safe and would grow, whether interest rates went up or down. Enforcement submitted Declarations that had been signed by three of Kline's other customers. Although none of the customers knew one another, all of their Declarations were consistent with Mr. SB's testimony, Mr. SB's Declaration, and the testimony and Declarations of the other Brookstone customers. The Hearing Panel therefore found that Kline's customers' Declarations were credible, despite the lack of testimony.

[87] CX-360A

Further, the customers' Declarations were supported by the testimony given by Brooks Brown, FINRA's examiner.[88] Brown testified that he spoke with all of the customers named in the Complaint between August and November 2007, years before the customers became infirm.[89] For every Declaration that Brown drafted, he spoke to the customers multiple times, making sure that he had noted the facts of their situations accurately. He then sent the Declarations back to the customers, and told them to sign the Declarations only if they were accurate.[90] Brown also testified that he tried to use the customers' own words as much as possible in the Declarations.[91] He evaluated the customers' memories by asking them what they recalled about their experiences with Kline, and their recollections are contained in the Declarations.[92]

Kline testified that four of the customers in this case--CP, JG, HP, and SB--were referred to him by insurance agents to whom he had made financial presentations. [93]

a. Customer Mrs. CP

Mrs. CP, age 84, and her husband, Mr. CP, who passed away in 2002, had both been retired for several years at the time that they met Kline in 2001. Mrs. CP worked as a home economics teacher for 27 years before her retirement. She had no understanding of investments and had relied on her husband to handle the family's investments. Mr. CP, who had some investment knowledge, but had never invested in CMOs before meeting Kline, had most of the

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[88] The SEC has upheld the use of affidavits to support findings in NASD disciplinary proceedings. *See Harry Gliksman*, 54 S.E.C. 471, 480-81 (1999) (finding customer affidavit, corroborated by NASD examiner's testimony regarding his conversations with customer, was admissible because it was probative and reliable), *aff'd*, 24 F. App. 704 (9th Cir. 2001).

[89] Tr. 1456.

[90] Tr. 1131-1132.

[91] Tr. 1460.

[92] Tr. 1575.

[93] Tr. 2994-2995.

contact with Kline. The CPs' investment experience consisted of long-term investments in blue chip stocks through accounts at Merrill Lynch. They had been unhappy with their Merrill Lynch accounts because they had experienced investment losses, and because margin had been utilized in their accounts against Mr. CP's wishes.[94] The CPs' total net worth (excluding primary residence) was approximately $4.5 million; liquid net worth was $4 million; and their annual income was approximately $50,000 (consisting of Social Security and $28,500 in pension payments from the New York State Teachers Association). Their investment objectives were to generate income for their living expenses and preservation of capital.

Kline told them that they could not lose money in CMOs because they were government-guaranteed bonds. Kline also agreed to reduce the margin balance in their accounts if they were transferred to him. Based on Kline's representations, the CPs agreed to open accounts at Brookstone. Although Kline initially reduced the margin balance in the accounts, after Mr. CP died, Kline increased the use of margin in Mrs. CP's accounts.

After Mr. CP's death, the CPs' son, Rene, began helping his mother with her investments and spoke to Kline on her behalf. When Rene asked Kline about the increased use of margin in Mrs. CP's accounts, Kline said that she could not lose money on the bonds, and that buying the bonds on margin was the only way to make money. Although Mrs. CP and her son both had very limited investment knowledge, Kline did not change the investment strategy in her accounts after Mr. CP's death. In fact, Kline traded Mrs. CP's accounts more aggressively in that he increased the use of margin in the accounts. He also changed the new account forms for the accounts to reflect a more aggressive investment objective.[95] For example, the 2004 new account forms for

[94] Tr. 250-251, 255-256, 333-334.

[95] Tr. 298-300.

Mrs. CP's accounts listed her risk tolerance as moderate and her investment objectives, in order of importance, as: growth, preservation of capital, income, aggressive income, and speculation.[96] However, the 2005 new accounts forms, which were completed for Mrs. CP by Kline after he moved to Brookstone, listed her risk tolerance as *moderate* and *aggressive income*, and her investment objectives, in order of importance, as: *growth*, *aggressive income*, *income*, *preservation of capital*, and *speculation*.[97] Another set of 2005 new account forms indicated that Mrs. CP had *moderate* and *aggressive income* risk tolerance, and that her investment objectives, in order of importance, were: *aggressive income, income, growth, preservation of capital,* and *speculation*.[98] There were no changes in Mrs. CP's personal circumstances between 2004 and 2005 that would explain the changes to the new account forms.[99]

In 2007, after being advised by her accountant that Mrs. CP's account had suffered significant loses, Mrs. CP's son transferred most of his mother's assets to another brokerage firm. Mrs. CP suffered losses of approximately $551,800 in connection with her CMO investments. The margin costs and commission expenses exacerbated the losses in her accounts.[100]

Brown testified that he spoke to Mrs. CP two or three times prior to early 2008. He had been discussing her declaration with her, but in early 2008, her health began to deteriorate, and she was not able to complete her declaration. At that point, Brown communicated with her son,

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[96] CX-98 at 3.

[97] CX-104 at 3.

[98] CX-105 at 2.

[99] Tr. 290-295.

[100] CX-363A.

Rene, about her account.[101] Brown testified that before her health began to deteriorate, she recalled significant amounts of information that he incorporated into her draft declaration.[102] Brown testified that from his discussions with Mrs. CP he determined that she had always relied on her husband to handle the family finances. Consequently, she had little investment knowledge or financial sophistication, and relied on Kline to make investment decisions after her husband's death.[103]

By the time of the hearing, Mrs. CP was suffering from dementia due to Alzheimer's disease and was unable to testify.[104] Her son, Rene, testified at the hearing that he tried to help his mother with her account after his father died and before she became ill. Rene testified that from conversations he had with his mother before she developed dementia, it was clear to him that she did not understand CMOs or the trading in her account. Rene also spoke several times to Kline in an effort to understand the trading in his mother's account. He testified that the trading never made sense to him. Rene's testimony at the hearing fully supported and corroborated the Brown's testimony about what Mrs. CP had told him.[105] Rene's testimony was consistent with Brown's testimony, as well as the testimony and Declarations of Kline's other customers. The Hearing Panel therefore found it credible and reliable.

b. Customer Mrs. JG

Mrs. JG, age 81, and her husband, Mr. JG, who died in 2005, were referred to Kline in 2002 by an insurance agent. Both of the JGs were retired when they met Kline. Before retiring,

[101] Tr. 1583-1584.

[102] Tr. 1293-1294, 1461, 1586, 1589,

[103] Tr. 1293-1294.

[104] Tr.1589.

[105] Tr. 255-256, 290-303.

Mr. JG had operated a shipyard and Mrs. JG had been a homemaker and a real estate agent. The JGs had previously lost money with other brokers, and were seeking income and safety for their retirement funds. They had very limited investment knowledge and had always relied on their brokers for investment advice. While he was alive, Mr. JG handled the family's investments and had most of the contact with the brokers. Prior to meeting Kline, the JGs had never invested in CMOs or purchased securities on margin. Their prior investment experience included investing in blue chip stocks, bonds, equity and bond mutual funds, variable annuities, and REITs through brokerage accounts at Raymond James and Merrill Lynch. Their total net worth (excluding primary residence) was $1.3 million; their liquid net worth was $1.3 million, and their annual income was approximately $20,000 (consisting of pension and Social Security).[106]

The JGs invested all of their retirement funds with Brookstone. Kline recommended that they use margin in their accounts. Because the JGs were unfamiliar with trading on margin, they asked Kline about the risks associated with using margin. He told them that using margin was a safe way to earn more income from the accounts.[107]

After Mr. JG's death, although Mrs. JG had very limited investment knowledge, Kline did not review or change his investment strategy to account for Mrs. JG's changed situation. In fact, Kline changed the new account forms for the accounts to reflect a more aggressive investment style. For example, the 2004 new account forms for the JGs' accounts, which were completed before Mr. JG's death, lists their risk tolerance as moderate and their investment objectives, in order of importance, as: *income*, *preservation of capital*, *aggressive income*, *growth*, and *speculation*. However, the 2005 new accounts form, which Kline completed for

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[106] CX-78.

[107] *Id*.

Mrs. JG after her husband's death and after Kline moved to Brookstone, listed Mrs. JG's risk tolerance as *moderate* and her investment objectives, in order of importance, as: *aggressive income*, *income*, *growth*, *preservation of capital,* and *speculation*. There were no changes in Mrs. JG's personal circumstances between 2004 and 2005 that would explain the changes on the new account forms. [108]

After Mr. JG passed away, the JGs' children became more involved in Mrs. JG's finances. Her son, John, a Wall Street equities trader, testified that he could not understand the investments in his mother's accounts, and that he began asking questions about falling values in 2007. John testified that he was still unable to understand the CMO trading strategy even after Kline explained it to him several times. By mid-2007, John decided that if could not understand the CMO trading strategy, then his mother, who had no securities experience, could not possibly understand it. He concluded that the strategy clearly entailed too much risk for his mother's accounts and ordered Kline to cease all trading activity.[109]

Mrs. JG' account lost approximately $342,100 during the Relevant Period. As with Mrs. CP's accounts, the margin costs and commission expenses exacerbated her losses in the rising interest rate environment.[110]

Mrs. JG was scheduled to testify at the hearing. But on the eve of the hearing, Brookstone agreed to settle her arbitration claim, which had been filed because of the losses sustained in her Brookstone account. Her son, John, was reluctant to testify, but appeared

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[108] CX-67 at 3; CX-70 at 3; CX-66 at 3.

[109] Tr. 696-705.

[110] CX-362A.

pursuant to a Rule 8210 request made by Enforcement. John testified that Mrs. JG had changed her mind about testifying because, as of the time of the hearing, Brookstone had not yet actually paid her the settlement funds. John said she was afraid that if she testified against Brookstone and Kline, they would not pay her. John said his mother desperately needed the funds from the settlement, because she now requires 24-hour nursing care. John's testimony corroborated his mother's Declaration. In addition, John had his own dealings with Kline and Brookstone, and his testimony about those dealings further supported his mother's Declaration.[111] Mrs. JG's Declaration was consistent with Brown's testimony and the Declarations of the other Brookstone customers, and the Hearing Panel therefore found it credible and reliable.

c. Customer Mr. HP

Mr. HP, who was age 85 at the time of his death on February 12, 2011, was drafted into the U.S. Navy at the age of 18, and never graduated from high school.[112] During FINRA's investigation of this matter, Mr. HP signed a Declaration describing his dealings with Kline. In his Declaration, Mr. HP stated that prior to his retirement in 1992, he had owned and operated business that made corrugated sheet metal. HP began investing in the 1990s when he opened accounts with Smith Barney. The money in the accounts, which represented the majority of HP's retirement funds, was invested in a diversified portfolio consisting of blue chip, midcap and small cap stocks, treasury notes, and bonds that were recommended by his financial advisors. HP became unhappy with his Smith Barney accounts after they lost money due to a downturn in the equity stock market and because margin was used in one of his accounts. Prior to meeting Kline in early 2002, HP had never invested in CMOs.

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[111] Tr. 689-692, 713-719, 734-737.

[112] Tr. 698-702; CX-176 at 2.

During HP's initial meeting with Kline, HP stated that he did not want to take much risk with his money at his age, and that his goal was to earn a steady interest income that he could live off of in his retirement. Kline recommended that HP invest in CMOs in order to attain his investment goals. Kline did not disclose any of the risks involved with the recommended CMO investments. When HP's accounts were transferred to Kline from Smith Barney in early 2002, they were worth over $2 million and represented nearly all of HP's liquid net worth. Soon after the accounts were transferred, Kline liquidated all of the stocks in the accounts, paid off an existing margin balance, and invested all of the remaining funds in CMO bonds. Kline also purchased CMOs on margin in HP's accounts.[113]

By 2006, the accounts had experienced significant losses due to falling market values of the CMOs, margin interest, and transaction costs. After sustaining substantial losses, HP moved his accounts away from Brookstone and Kline.[114] In total, HP's accounts lost approximately $258,800 as a result of his investments in the CMOs recommended by Brookstone and Kline.[115]

Brown testified that he interviewed Mr. HP multiple times, and concluded that Mr. HP was financially unsophisticated, and that he had always relied on brokers for investment advice. Brown's testimony fully supported HP's Declaration.[116] In addition, Mr. HP's Declaration was consistent with the testimony and Declarations of the other Brookstone customers. The Hearing Panel therefore found Mr. HP's Declaration to be credible and reliable.

[113] CX-178.

[114] HP also retained an attorney, who sent a letter to Brookstone and Kline demanding that HP be compensated for his losses. CX-176. At the time of his death, HP had not received any compensation from Brookstone or Kline.

[115] CX-364A.

[116] Tr. 1152, 1322-1330.

d. Customer Mr. SB

Mr. SB, age 98, was referred to Kline in 2002 by an insurance agent. At that time, SB was a retired school teacher with limited investment knowledge. His investment experience consisted primarily of investing in mutual funds, corporate and municipal bonds and annuities. SB's financial situation at the time he invested with Kline included total net worth (excluding primary residence) of approximately $1,365,000 ($900,000 invested in annuities, $315,000 invested in brokerage accounts, and $150,000 in a real estate investment); liquid net worth of approximately $315,000; and annual income of approximately $55,000 (consisting of pension income, Social Security, and investment income).[117]

During his initial meeting with Kline, SB told Kline that he wanted his investments to be safe and secure. Kline recommended that SB transfer his accounts to him and invest in CMOs. Kline told SB that the CMOs would be guaranteed by the government, that they would be safe, and that they were paying high interest, as much as 15 to 20 percent. Kline did not mention any risks involved with CMO investments. Based on Kline's representations, SB believed that the CMO investments would be safe and secure and, accordingly, agreed to transfer his Raymond James brokerage account to Kline. Mr. SB also transferred a Smith Barney account to Kline.[118] Kline liquidated the securities in the accounts and invested all of the proceeds in CMOs. When SB discovered that Kline was also utilizing margin to purchase CMOs, SB told Kline that he had heard that trading on margin was speculative and risky, and that he did not want or need that kind of risk.[119] Kline subsequently ceased margin trading in SB's accounts.

[117] CX-355 at 18-22.

[118] CX-49; CX-355 at 18-31.

[119] CX-49 at 2; CX-355 at 65-67, 93, 135-136.

Like Kline's other customers, SB followed Kline each time he changed firms. As with other customers, SB's investment objectives on new account forms were changed for no apparent reason. The new account form SB signed on January 5, 2004, showed his investment objectives, in order of importance, as: *preservation of capital, income, aggressive income, growth* and *speculation*. However, an updated form dated May 4, 2004, listed SB's investment objectives, in order of importance, as: *aggressive income, income, preservation of capital, growth* and *speculation*. There were no changes in SB's personal circumstances between January and May 2004 that would explain the changes on the two sets of new account forms. When his accounts were opened at Brookstone in 2005, SB's new account paperwork reflected the more aggressive investment objectives. [120]

Over the years, Kline sent SB numerous pieces of written correspondence that contained many of the same verbal representations that Kline had made to SB to induce him to transfer his accounts to Kline, and later to lull SB into staying the course when his accounts were not performing well. Kline's representations included telling SB that the primary features of CMO bonds included "AAA rating, high level of monthly income, growth/capital gains, and asset protection."[121] Kline also told SB that his portfolio would be "constructed to maximize both return and safety."[122] Furthermore, Kline told SB that CMOs were suitable for "retired persons seeking additional income and safety."[123]

In 2006, SB's CPA informed him that he had lost $50,000 in his accounts with Kline. When SB asked Kline about the losses, Kline told him not to worry about it, and that the

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[120] CX-44, at 3; CX-43 at 4.

[121] CX-313.

[122] *Id.*

[123] CX-314 at 3.

accounts were doing fine. Kline also explained that if SB waited long enough, everything would come back. In April 2007, SB decided to transfer his accounts back to his former broker at Raymond James. During the Relevant Period, SB's accounts lost approximately $26,800 in connection with the CMO investments at Brookstone.[124]

Because of SB's advanced age, Enforcement took his video deposition, which was attended by Respondents' counsel, who was able to cross-examine SB.[125] Although his cross-examination was not completed, the Hearing Panel found that the two-plus hours of cross-examination was approximately equal to the direct examination conducted by Enforcement, and provided Respondents a fair opportunity to test SB's version of events. The Hearing Panel found that SB's memory was not complete, but supported his Declaration. In addition, Mr. SB's testimony and Declaration were consistent with Brown's testimony, and with the testimony and Declarations of other Brookstone customers. The Hearing Panel therefore found Mr. SB's testimony and Declaration to be credible and reliable.

e. Customer Mr. LD

Mr. LD, a 69-year-old retired school building engineer, lived next door to Kline in Florida. Mr. LD refused to testify at the hearing. He signed a sworn Declaration in January 2008, which provided a basis for Enforcement's allegations about Kline's mishandling of Mr. LD's account. [126] According to Kline, Mr. LD called Kline sometime in 2011 and told Kline that he did not believe Kline had mishandled MR. LD's account. Kline asked Mr. LD to speak to Kline's attorney, who prepared an Affidavit of Support for LD to sign. The Affidavit of Support,

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[124] CX-358A.

[125] CX-355.

[126] CX-60; Tr. 1624, 1626,

which Mr. LD signed on May 23, 2011, repudiated his prior Declaration.[127] In light of Mr. LD's repudiation of his earlier statements, the Hearing Panel dismisses the claims with respect to Mr. LD for lack of evidence.

III. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Brookstone, Turbeville, and Kline Violated § 10(b) of the Exchange Act, Rule 10b-5 thereunder, and Rules 2120 and 2110 by Making Fraudulent Misrepresentations and Omissions

1. Findings of Fact

The Hearing Panel found that Brookstone, Turbeville, and Kline intentionally or recklessly misrepresented the CMO investments to their customers as a safe way, through government-backed bonds, to obtain a high rate of return on their investments. In reality, the CMOs the brokers purchased for the customers were high-risk investments whose returns were not assured, but instead, because of interest rate changes, were subject to dramatic changes in maturity, cash flow, and value. Although the bonds were explicitly or implicitly guaranteed by the U.S. government, such guarantees only limit the *credit* risk inherent in bonds—the risk that the bonds will default. The government guarantee does nothing to reduce the greater risks of CMOs generally, and IFs in particular—interest rate sensitivity. There was no reasonable basis for the representations the Respondents made to their customers.

Turbeville's customers stated that he told them that it was reasonable for them to expect a 10% average annual return on their investments in CMOs. Turbeville told two customers (MR and BC) that they should expect at least 10% average annual returns on their investment, and 15% if they allowed him to trade on margin, whether interest rates went up or down.[128]

[127] RX-96, RX-101, CX-326; Tr. 2858-2862.

[128] CX-32 at 1, CX-17 at 6.

Moreover, Turbeville made the same representations in the *Financial Profile* that he prepared for MR.[129]

In light of the speculative nature of the investments recommended by Turbeville and the significant risk of loss involved, it was reckless for him to represent to customers that they should expect to receive such a high rate of return. The fact that market interest rates were at or near historic lows during the time period of the representations is further evidence of the unreasonableness of the representation. Turbeville's projections also failed to take into account the customers' ongoing transaction costs, which were over 4% annually for most cash accounts reviewed, and over 10% for margin accounts, due to margin interest costs.

Kline misrepresented to his customers that the CMO investments were guaranteed by the U.S. government and that they could not lose money. In reality, most of the "government bonds" were issued by government-sponsored entities such as Fannie Mae and Freddie Mac, which did not guarantee against losses on investments. As evidenced by the extensive customer losses, it was clearly possible to lose money with these investments. Further, Kline misrepresented to his customers that he was managing their accounts. Instead, after bringing customers into the Brookstone CMO program, he turned over management of the accounts to persons outside of Brookstone—Green and Utne. After some of Kline's customers wanted to move their accounts because of losses, Kline wrote an email to Green and Utne, saying, "I'm busy trying to raise money which means I have always left the management of the portfolios to you guys…. If I am not actually managing the account, there is no way I am going to take all the responsibility when something like this takes place."[130]

[129] CX-334.

[130] CX-270 at 1.

Additionally, the Respondents intentionally or recklessly failed to disclose material facts about the CMOs that they purchased and allocated to their customers. Specifically, the Respondents did not disclose the characteristics and various risks associated with the different CMO payment structures and interest rate sensitivity. They also failed to disclose the risks associated with utilizing margin to purchase CMOs. In particular, the Respondents failed to disclose that interest income might not exceed margin interest charges incurred, that due to ongoing commission and interest charges, the accounts might require as much as a 15% return in order to generate a profit, and that the registered representative would have full discretion over the degree to which margin would be used in a given account.[131]

2. Conclusions of Law

A violation of §10(b) of the Exchange Act and Rule 10b-5 is established when the following elements are proved: (i) a misrepresentation, an omission where there is a duty to speak, or other fraudulent device; (ii) in connection with the purchase, or sale of securities; (iii) requisite intent, i.e., scienter on the part of the respondent;[132] (iv) the misrepresentation or omission is material; and (v) the use of any means or instruments of transportation or communication in interstate commerce, or of the mails, or of any facility of any national securities exchange.[133]

Rule 2120 provides that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." The elements of a Rule 2120 violation are the same as listed above for

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[131] CX-353.

[132] *See Aaron v. SEC*, 446 U.S. 680, 701-702 (1980).

[133] *See SEC v. First Jersey Sec., Inc.*, 101 F. 3d 1450, 1467 (2d Cir. 1996); *see also DBCC v. Euripides*, No. C9B950014, 1997 NASD Discip. LEXIS 45, *18 (NBCC July 28, 1997).

Rule 10b-5, except that there is no requirement to prove use of interstate commerce, the mails or any facility of any national securities exchange.[134]

a. Misrepresentations and Omissions

Brookstone, Turbeville, and Kline falsely represented to customers that the CMOs they recommended were safe, government-backed bonds, with little to no risk to principal. Brookstone and Turbeville also told customers to expect annual returns of at least 10%, and at least 15% if margin was used, without any reasonable basis for making such representations. Furthermore, Brookstone and Kline told customers that the CMO investments were guaranteed by the U.S. government and that they could not lose money. In reality, most of the CMOs sold to customers were issued and guaranteed by certain government-sponsored entities such as Fannie Mae or Freddie Mac, which did not provide guarantees against loss of principal.

Brookstone, Turbeville, and Kline also failed to adequately disclose the various risks associated with the CMOs that they recommended to customers. The Respondents failed to tell their customers that CMOs are highly risky securities, subject to dramatic changes in maturity, cash flow, and liquidity based on relatively minor changes in interest rates. They also failed to disclose the additional risks associated with the use of margin.

b. The Misrepresentations and Omissions Were Material

Each of the Respondents' misrepresentations and omissions was material in light of the complexity and risks associated with the recommended CMOs.[135] The U.S. Supreme Court has held that "materiality depends on the significance the reasonable investor would place on the

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[134] *Euripides*, 1997 NASD Discip. LEXIS 45, at *18 (setting forth the elements of a Rule 2120 violation).

[135] *See Dep't of Enforcement v. Gebhart*, No. C02020057, 2005 NASD Discip. LEXIS 40, at *40-41 (NAC May 24, 2005) (holding that failures to disclose risks associated with an investment involved material omissions), *aff'd*, 2006 SEC LEXIS 93.

withheld or misrepresented information."[136] A fact is material if there is a substantial likelihood that a reasonable investor would consider the information to be important in making an investment decision.[137] Additionally, "undisclosed information is material if there is a 'substantial likelihood' that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."[138]

The representations and omissions by the Respondents were material to the customers, and would have been material to any reasonable investor. Without information regarding the essential characteristics and risk associated with the CMOs, the investor could not make an informed investment decision.[139]

c. Respondents Acted With Scienter

Scienter has been defined as "a mental state embracing intent to deceive, manipulate, or defraud."[140] A showing of recklessness is sufficient to establish that the Respondents acted with scienter.[141] "Reckless conduct has been defined as a highly unreasonable misrepresentation or omission, involving not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers

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[136] *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232, 240 (1988).

[137] *Id.* at 231-32.

[138] *Id.*

[139] *See Kenneth R. Ward*, 2003 SEC LEXIS 687, *38-42 (Mar. 19, 2003) (The SEC determined that recommendations of inverse floaters to an institutional investor by the representative were materially misleading because the representative failed to highlight the risks set forth in NASD NTM 93-73, including that "inverse floaters are highly risky securities, subject to dramatic changes in maturity, cash flow, and liquidity based upon relatively minor changes in interest rates.").

[140] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

[141] *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990).

that is either known to the defendant or is so obvious that the actor must have been aware of it."[142]

Importantly, a broker "cannot recommend a security unless there is an adequate and reasonable basis for such recommendation."[143] A salesman has a duty to refrain from recommending securities unless he possesses an adequate and reasonable basis for his recommendations.[144] Additionally, a salesman must disclose material facts that he knows and those that are reasonably ascertainable.[145]

The evidence supports the conclusion that Brookstone, Turbeville, and Kline acted intentionally or recklessly, and, therefore, with scienter, when they solicited their respective customers to purchase CMO securities and made misrepresentations and omitted facts in connection with those purchases.

The Hearing Panel found by a preponderance of the evidence that Brookstone, Turbeville and Kline violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and violated Rules 2120 and 2110.

B. Negligent Misrepresentations and Omissions (Alternative to Fraud Charge): Violation of NASD Conduct Rule 2110 (Brookstone, Turbeville and Kline)

The Hearing Panel found by a preponderance of the evidence that the Respondents committed fraud, as alleged, and the charge of negligent misrepresentations is subsumed within the fraud charge.

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[142] *Dep't of Enforcement v. Abbondante*, No. C10020090, 2005 NASD Discip. LEXIS 43, at *28 (NAC Apr. 5, 2005) (citations omitted), *aff'd*, Exchange Act Release No. 53066, 2006 SEC LEXIS 23 (Jan. 6, 2006), *aff'd*, 2006 U.S. App. LEXIS 30982 (2d Cir. Dec. 12, 2006); *see also Hollinger v. Titan Capital Corp.*, 914 F.2d at 1568-1569.

[143] *Hanly v. SEC*, 415 F.2d 592, 597 (2d Cir. 1969); *see also Hiller v. SEC*, 429 F.2d 856, 858 (2d Cir. 1970).

[144] *Hanly*, 415 F.2d 595-97.

[145] *Id*.

C. Brookstone, Turbeville, and Kline Violated Rules 2310(a) and 2110 by Making Unsuitable Recommendations to Customers

1. Findings of Fact

Turbeville and Kline claimed that their CMO strategy was suitable for their customers because the customers understood the risks involved in the strategy and knowingly assumed high risks in order to obtain above-market returns. As evidence of the customers' supposed willingness to accept the high degree of risk involved in the Brookstone CMO strategy, Turbeville and Kline pointed to the "investment objectives" portion of the new account forms that Brookstone used. At or near the beginning of the Relevant Period, the Respondents had all of the customers sign new account forms indicating that "aggressive income" was their primary investment objective.[146] Turbeville, Kline, and their supervisor, Locy, all testified that IFs and other CMOs were suitable for customers who sought "aggressive income."[147]

However, the weight of the evidence contradicted the Respondents' claims. The Hearing Panel found that aggressive income was not, in fact, the customers' primary objective. The customers who testified all stated that their main objective was to preserve their assets so that they could obtain a moderate income in their retirement years. This testimony was consistent with other Brookstone customer Declarations, and with what the customers told Brown. The Hearing Panel found that the customers were uniformly risk-averse. The new account forms came to them already filled out, and many of the terms on the forms were vague and confusing. The customers signed the forms because the brokers told them that the information on the new

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[146] *See, e.g.*, CX-014, at 6; CX-019, at 3; CX-025, at 2; CX043, at 4; CX-058, at 3; CX-066, at 3; CX-105, at 2; CX-175, at 3.

[147] Tr. 2173, 2294-2295, 2978-2979.

Brookstone forms had simply been transcribed from their forms at the previous brokerage firm. In fact, the investment objectives had been changed from more conservative to more aggressive.

When asked at the hearing to explain how the CMOs and inverse floaters were suitable for these individual customers, Turbeville and Kline claimed that all of the customers wanted to participate in the CMO strategy for its income potential and understood all of the risks of doing so. But the very document Respondents point to for evidence of the customers' investment objective undermines this argument. The new account application that Brookstone used during the relevant time period states that the objective of "aggressive income" indicates a willingness to accept only a *moderate* risk of loss of principal.[148] Thus, according to Brookstone and the other Respondents, an investment objective of "aggressive income" does not indicate a willingness to speculate or assume a high risk exposure.

The evidence shows that the customers' risk tolerances were actually even more conservative than the Respondents contend. Respondents ignore, for example, the fact that the new account forms contain other investment objectives, such as "Preservation of Capital," which admit much less tolerance for risk.[149] Ms. BC, Mr. SB, and Mr. and Mrs. MR all testified credibly that they were most concerned about preserving their capital.[150] Mrs. BB, Mrs. JG, and Mr. HP provided written declarations stating that they were willing to tolerate either a low or low-to-moderate risk of loss to principal.[151]

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[148] CX-14 at 6.

[149] *See, e.g.,* CX-014, at 6 ("An investment objective of Preservation of Capital indicates you seek to maintain the principal value of your investments and are interested in investments that have historically demonstrated a very low degree of risk of loss of principal value.")

[150] Tr. 42-43, 444-451, 607; CX-326 at 13-14.

[151] CX-23 at 1, CX-78 at 1, CX-178 at 1.

Moreover, "investment objective" was not the only factor the Respondents should have considered in making recommendations—age and investment horizon were particularly important for this group of customers, all of whom were retired by the end of the Relevant Period.[152] Six customers were at least 72 years old,[153] and the oldest (SB) was 91.[154] Mrs. BB, Mrs. JG, and Mrs. CP were widows who had always depended on their husbands to handle their investments. Ms. BC lived alone and, at age 61, had less than $300,000 in principal to fund her entire retirement.[155]

Respondents attempted to downplay the importance of steep drops in IF prices during times of rising interest rates because—as Turbeville and Kline repeatedly reminded their CMO customers—these bonds would eventually pay off at par value. However, Turbeville and Kline did not hold the bonds to maturity. Instead, they routinely sold the customers out of the CMOs at steep discounts from the prices they originally paid for them, and then used the proceeds of sales at steep discounts to purchase bonds that were not steeply discounted, thereby locking in the customers' losses and preventing the possibility of waiting for the bonds to pay off at par.[156]

At the hearing, the Respondents argued that NTM 93-73 is outdated, and that, by 2005, CMOs were no longer the risky investments described in that Notice. Respondents' expert witness, MacLaverty, testified that there is greater "transparency" in the CMO market than in 1993, and that there is greater understanding of how to manage the risk of CMOs.[157] But

[152] After retiring from a 30-year career with Publix Super Markets, BC returned to work as a teacher's aide before retiring again in 2010. Tr. 36-37.

[153] CX-357A

[154] CX-358A

[155] Tr. 42-43.

[156] CX-353.

[157] Tr. 3249-3250.

MacLaverty also acknowledged that IFs work the same way and carry the same risks as they always have. That is, they are highly sensitive to interest-rate changes, most notably because they are internally leveraged.[158] Thus, regardless of any expansion in the market for CMOs, changes in interest rates cause extreme price volatility in IFs. Nothing about IFs or other CMOs makes them any more suitable for unsophisticated, individual investors with moderate-risk profiles than they were when NTM 93-73 was issued.

Turbeville and Kline gave no meaningful consideration to their customers' individual financial situations when they brought them into the CMO program. And once those customers were in the CMO program, the brokers continued to treat them as little more than interchangeable accounts, thereby continuously failing in their obligation to assess individual customer suitability for each transaction. From July 2005 through July 2007, Turbeville and Kline traded the customers' CMO accounts according to buying power, not according to any individual customer's needs or goals.[159] They bought and sold in large blocks, and allocated newly purchased CMOs to customers according to the cash available in their accounts. As Kline testified, there was no way to tailor the CMO strategy to suit any individual customer's characteristics.[160] Turbeville and Kline therefore ignored major events in their customers' lives that should have affected any reasonable suitability analysis, such as retirement, the death of a spouse, or the need for costly medical care.

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[158] Tr. 3248-3249.

[159] Tr. 1160, 1414-1415.

[160] Tr. 2835-36

Turbeville and Kline contend that their CMO customers understood, accepted, and were willing to tolerate the risks involved in the CMO strategy. As evidence of this, they pointed to various disclosures that they purportedly made to their customers, both verbally and in writing. Yet the Respondents failed to disclose the significant risks involved in CMO trading, as described in NTM 93-73. Indeed, Turbeville was not even aware of the Notice until FINRA investigators brought it to his attention. And, while Kline claimed that he was aware of the Notice, he did not follow its guidance when recommending CMOs to his customers. The Hearing Panel found that regardless of the disclosures purportedly made by the Respondents, the strategy was so complex that none of their customers understood it, and were thus unable to fully appreciate the risks inherent in the CMO trading.

2. Conclusions of Law

NASD Rule 2310(a) requires associated persons to have reasonable grounds for believing that a recommendation is suitable for customers based on the facts, if any, disclosed by the customer as to his or her other security holdings and financial situation and needs.[161] Because Turbeville and Kline used discretion to trade their customers' accounts, each transaction also constituted a "recommendation," requiring them to comply with Rule 2310 (a).[162] Pursuant to Rule 2310(a), Turbeville and Kline were required to tailor their investment recommendations to each customer's financial profile and investment objectives.[163]

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[161] *See* NASD Conduct Rule 2310; *see also Larry Ira Klein*, Exchange Act Rel. No. 37835, at 10 (Oct. 17, 1996).

[162] *See Patrick G. Keel*, Exchange Act Rel. No. 31716, 1993 SEC LEXIS 41, at *5 (Jan. 11, 1993) (in executing transactions on behalf of customers, without prior communication with the customers, the broker implicitly recommended the securities).

[163] *F.J. Kaufman and Company of Virginia*, Exchange Act Rel. No. 27535, 1989 SEC LEXIS 2376, at *9 (SEC Dec. 13, 1989).

For nearly 20 years, FINRA has advised its members that CMOs are not appropriate for ordinary investors. As noted above, NTM 93-73 states that "certain tranches may be structured in such a way that, depending on interest rates and prepayments, investors are at substantial risk and may lose all or a substantial portion of their principal."[164] Moreover, NTM 93-73 specifically states that inverse floaters "are only suitable for sophisticated investors with a high-risk profile …."[165] The suitability concerns regarding inverse floaters and other CMOs have not lessened since the Notice was issued. CMOs continue to be "complex investment products, difficult to evaluate and suitable primarily for sophisticated or institutional investors."[166]

Nevertheless, the Respondents constructed portfolios for their customers that consisted almost exclusively of CMOs, and were heavily—at times nearly entirely—concentrated in IFs. The customers were lured into the CMOs by the Respondents' assurances of high returns. The Hearing Panel found that none of the customers wanted to subject his or her retirement savings to a significant risk of loss, not even for the possibility of generating a high return. Turbeville and Kline disregarded their customers' objectives and risk profiles and invested each customer's retirement assets in products that are generally unsuitable for individual investors. They did so knowing that none of these customers was a sophisticated investor or someone for whom high-risk investments were suitable. They did so, moreover, without taking any meaningful steps to control the overall interest-rate sensitivity within each portfolio.

[164] NTM 93-73, *Members' Obligations to Customers When Selling Collateralized Mortgage Obligations (CMOs).*

[165] *Id.*

[166] *Dep't of Enforcement v. Richard G. Cody,* No. 2005003188901 (OHO Jan. 29, 2009).

Even assuming that all of the customers wanted "aggressive income," a customer's stated investment objective is only one fact a broker must consider when assessing suitability. "[A] broker cannot rely upon a customer's investment objectives to justify a series of unsuitable recommendations that may comport with the customer's stated investment objectives but are nonetheless not suitable for the customer, given the customer's financial profile."[167] Here, because the transactions at issue involved IFs and other CMOs, the most relevant aspect of the customers' financial profiles was that they were all unsophisticated individuals. For such investors, CMOs, particularly IFs, are almost presumptively unsuitable. Respondents have not articulated why a purported desire for "aggressive income" should trump long-standing FINRA guidance and precedent stating that CMOs are generally not suitable for individuals, and that IFs are suitable only for high-risk, sophisticated investors.

Even if the Respondents had fully disclosed all of the risks involved in trading CMOs, such disclosure is insufficient for meeting their suitability obligations. As in the case of *DOE v. James B. Chase,* in which the respondent made the same argument concerning disclosure, the Respondents in this case "demonstrated a profound lack of understanding of [their] customer-specific suitability obligation under Rule 2310."[168] As the NAC stated in that decision, "Although it is important for a broker to educate clients about the risks associated with a particular recommendation, the suitability rule requires more from a broker than mere risk disclosure."[169] Turbeville and Kline had an obligation to assess suitability for each customer and

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[167] *Dep't of Enforcement v. James B. Chase*, No. C8A990081, 2001 NASD Discip. LEXIS 30, at *24 (NAC Aug. 15, 2001); *see also John M. Reynolds*, 50 S.E.C. 805, 809 (1992) (stating that regardless of whether the customer wanted to engage in aggressive and speculative trading, the broker was obligated to abstain from making recommendations that were inconsistent with the customer's financial situation).

[168] *Id.*

[169] *Id.* (citing *Patrick G. Keel*, 51 S.E.C. 282, 286 (1993)).

for each CMO transaction that was wholly independent of the customer's understanding of the transaction or desire to proceed with it. Disclosure of risk does not negate the obligations imposed by Rule 2310. Likewise, even if a customer wants to engage in risky trading, a broker has a "duty to refrain from making recommendations that are incompatible with the customer's financial profile."[170] As the SEC has stated, "A recommendation is not suitable merely because the customer acquiesces in the recommendation. Rather, the recommendation must be consistent with the customer's financial situation and needs."[171]

Both Turbeville and Kline attempted to portray their customers as greedy or irresponsible in seeking to earn high rates of income from their investments. Turbeville, for example, testified that Ms. BC demanded that he invest her limited retirement savings in a manner that would produce enough income for her to retire, even though Turbeville did not believe she had sufficient money set aside for her to retire early. Nonetheless, Turbeville recommended the CMO program to Ms. BC.[172] Kline testified that he believed that Mrs. JG was living beyond her means, but because she insisted on earning a high rate of income from her investments, he put her in the CMO program.[173] Turbeville's and Kline's actions with respect to BC and JG further show that the Respondents abdicated their responsibilities under Rule 2310. "Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are

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[170] *Dep't of Enforcement v. William J. Murphy*, No. 2005003610701, 2011 FINRA Discip. LEXIS 42, at *72 (NAC Oct. 20, 2011).

[171] *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *24 (Feb. 10, 2004).

[172] Tr. 1848-1849.

[173] Tr. 2698.

incompatible with the customer's financial profile."[174] In short, the suitability rule requires that a broker's recommendations "be consistent with his client's best interests."[175]

Turbeville and Kline each claim that they are blameless because interest-rate movements are unpredictable and because what happened from 2005 to 2007 was unprecedented. But what actually happened with interest rates and how the investments performed after Turbeville and Kline purchased them are not the relevant considerations when assessing suitability. Instead, the relevant inquiry is whether, given what they knew about their customers' financial needs and objectives, Turbeville, Kline, and Brookstone subjected the customers to excessive risk. The Hearing Panel finds that they did, and, moreover, that they did so intentionally and repeatedly and without any reasonable basis for believing that IFs and other CMOs were suitable for these customers.

Throughout the period at issue in this case, Turbeville and Kline knew that interest rates were unpredictable. They understood that the bonds they were buying for their customers were subject to interest-rate risks and would suffer in a rising-rate environment. Essentially, they predicted that interest rates would stay the same or decline, and they then gambled with their customers' money. When interest rates defied the Respondents' predictions, their customers lost money. Turbeville, Kline, and Brookstone had no reasonable basis for believing that the degree of risk involved in investing heavily in CMOs was suitable for the customers whose accounts are at issue here.

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[174] *Jack H. Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *8 (Feb. 10, 2003).

[175] *Dep't of Enforcement v. Dunbar*, No. C07050050, 2008 FINRA Discip. LEXIS 18, 20 (NAC May 20, 2008) (citing *Belden*, 2003 SEC LEXIS 1154, at *11; *Larry Ira Klein*, 52 S.E.C. 1030, 1037, 1996 SEC LEXIS 2922 (Oct. 17, 1996).

Turbeville, Kline, and through them, Brookstone, cannot abdicate their obligation to make suitable investment recommendations to their customers. Regardless of what the customers understood about the riskiness of the investments, Turbeville and Kline had an ongoing obligation to recommend only transactions that were suitable for each individual customer on whose behalf the transactions were made.

Based on the foregoing, the Hearing Panel found that Brookstone, Turbeville, and Kline made unsuitable investment recommendations in violation of Rule 2310(a). A violation of one FINRA rule is also a violation of Rule 2110.[176]

D. Brookstone and Turbeville Violated Rules 2210(d)(1)(A) and 2210(d)(1)(B) by Sending Misleading Letters to Customers

Rule 2210(d)(1) sets forth the content standards "Applicable to All Communications with the Public." The Rule provides in relevant part that all such communications

> (A) [S]hall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security. . . . No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communication to be misleading.
>
> (B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

Brookstone and Turbeville made misrepresentations, omitted material facts and used misleading statements in letters that Turbeville sent to his CMO customers on April 5, 2006, and May 4, 2006.[177] Turbeville sent the letters to his customers in an apparent attempt to quell the

[176] *Stephen J. Gluckman*, 54 S.E.C. 175, 185 (July 20, 1999); *see also Charles C. Fawcett, IV*, Exchange Act Rel. No. 56770, 2007 SEC LEXIS 2598, at *11-12 (Nov. 8, 2007) (stating that violations of FINRA rules are inconsistent with just and equitable principles of trade and constitute a violation of Rule 2110).

[177] CX-10.

customers' concerns about rising interest rates. The April 5, 2006 letter violated NASD Rule 2210(d)(1)(A) by failing to provide a sound basis for evaluating the information presented. For example, Turbeville lacked a sound basis for the statements: "[w]e are on the back end of the interest rate increase cycle" and "[a]lso remember, at some point, interest rates should again, begin to fall."[178]

Brookstone and Turbeville also violated NASD Rule 2210(d)(l)(A) by omitting material information from the May 4, 2006 letter. For example, the letter stated, "[w]hat this means to you is that holding the bonds to life will result in a return of principal value plus interest due along the way" and "[t]he average life of bonds in your portfolio is 3-5 years."[179] The letter failed to disclose that interest earned on IFs would decline as current interest rates rose, and that the CMOs' average lives would fluctuate depending on changes in current interest rates and the actual rate at which mortgage holders prepaid underlying mortgages.

Furthermore, the letters also violated NASD Rule 2210(d)(1)(B), in that they contained misleading statements. For example, the April 5, 2006, letter contained the following statements: "look at each bond on your statement as 100 instead of its current value" and "Your account continues to produce income while it matures back to Par" and "by holding the bonds to maturity you will receive the principal value (face value) back, plus any interest due." These statements misled customers by falsely implying that the customers would hold those bonds until they matured at 100, when Turbeville was actually selling the bonds before they matured.

The "Value at Par (All Accounts with Margin Balance)" document that was attached to the May 4, 2006 letter sent to customers was misleading in that it failed to provide material

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[178] *Id.* at 1.

[179] *Id.* at 3.

information regarding the data presented within the “Current Price,” “Current Factor,” and “Value at Par” columns. There was also no disclosure pertaining to the date and time that the Current Price data was calculated; no explanation of the Current Factor data, including how its applied; no explanation of par value and no clear disclosure that the par values cited are not actual market values of the listed CMOs; and no disclosure referring the customer to a source for the current market value of the listed CMOs.[180]

The Hearing Panel found that Turbeville and Brookstone intentionally violated Rules 2210(d)(1) and 2110 by sending customers letters that did not have a reasonable basis for the representations made, and misrepresented and omitted material facts about their investments.

E. Brookstone and Locy Violated Rules 2510(c) and 2110 by Failing to Review Discretionary Accounts

1. Findings of Fact

From July 2005 through July 2007, Locy was Brookstone’s chief compliance officer and Turbeville’s supervisor. During his testimony, Locy admitted that aside from initially approving new accounts and approving CMO transactions, he did not periodically review Brookstone clients’ discretionary accounts. He claimed that his random monthly account reviews included discretionary and margin accounts; however, he could not identify any instances in which he had reviewed a CMO cash or margin discretionary account during his monthly reviews. And he admitted that he did not have any documentation to substantiate his claims that he ever reviewed discretionary accounts. [181]

[180] *Id.* at 4-6.

[181] Tr. 2391.

In addition, Brookstone's procedures required that a principal of the firm speak directly with each discretionary account customer at least annually to determine the customer's level of satisfaction, and that such client contact be documented and maintained by the chief compliance officer.[182] Locy admitted that, although he was responsible for performing these tasks, he had never contacted customers regarding their level of satisfaction with their discretionary accounts.[183]

2. Conclusions of Law

NASD Rule 2510(c) provides that "[t]he member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account."

As discussed above, Brookstone, acting through Locy, failed to review all discretionary accounts at frequent intervals in order to detect and prevent transactions that were excessive in size or frequency in view of the financial resources and character of the account, as required by Rule 2510(c). In his testimony, Locy could not identify any instance in which he had periodically reviewed the firm's discretionary accounts.

Accordingly, the Hearing Panel found by a preponderance of the evidence that Brookstone and Locy violated Rules 2510 (c) and 2110.

[182] CX-307 at 60.

[183] Tr. 2513.

F. Brookstone, Turbeville, and Locy Violated Rules 3010(b) and 2110 by Failing to Adequately Supervise Customer CMO Accounts and Transactions

1. Findings of Fact

Locy served as Brookstone's chief compliance officer and as Turbeville's and Kline's supervisor throughout the period from July 2005 through July 2007. As such, he was responsible for supervising all of the CMO transactions and accounts at issue in this matter. Locy should have been the first line of defense against the unsuitable transactions. Locy, however, abdicated his responsibility to supervise by relying solely on representations made by Turbeville and Kline in assessing the suitability of the CMO transactions for the customers and ignoring red flags indicating that the CMO investments were unsuitable for certain customers. For example, Locy failed to investigate the high number of CMO accounts that were owned by customers who were retired and/or over the age of 65, or had what was no greater than a moderate risk tolerance, yet were investing in high-risk securities and/or trading on margin.[184]

The evidence shows that Locy barely made any effort to learn what was happening in any of the customers' accounts. Although all of the accounts were discretionary, and many utilized margin, he did not review the accounts or monitor the trading in them. He did not contact customers to ensure that the investments were suitable for them, and that they understood the trading in their accounts. Because Locy failed to conduct any meaningful review of the accounts, he did not recognize that the concentration of CMOs in some of those accounts exceeded 75% of the customer's liquid net worth, and that some of the "moderate" risk tolerance customers had

[184] Tr. 2519-2523.

accounts consisting largely of CMOs purchased on margin. Locy admitted that he was not even aware of the concept of effective duration as a measure of interest rate sensitivity of CMOs.[185]

In addition to the customers who are at issue in this action, the record shows that Turbeville and Kline recommended Brookstone's CMO strategy to all sorts of customers with a vast array of suitability profiles, from single mothers with dependent children, to customers in their 40s with "aggressive" risk tolerance, to retirees in their 80s with only "moderate" tolerance for risk[186] and a liquid net worth of less than $100,000.[187] Locy never questioned the suitability of the CMO transactions for any of these customers, either. As a result of Locy's lethargic approach to supervision, there was no real oversight and no meaningful protection for any of Brookstone's CMO customers against the unsuitable investment recommendations made by Brookstone brokers.

During the Relevant Period, Brookstone, acting through Turbeville and Locy, also failed to enforce Brookstone's procedures regarding safeguarding customer information. Specifically, although Turbeville and Locy knew or should have known that Doug Green and his unregistered assistant, Robert Utne, routinely used their personal *Hotmail* and *AOL* Internet-based email accounts to send and receive confidential Brookstone customer account information, they failed to take any action to prevent the customer's information from being compromised. In allowing Green and Utne to transmit confidential customer account information over unsupervised, web-based email accounts, Brookstone failed to enforce its written procedures regarding the adequate

[185] Tr. 2524; CX-185.

[186] *See, e.g.,* CX-190 (63-y.o. retiree with "aggressive" risk tolerance), CX-197 (54-y.o. married woman with one dependent child and "moderate" risk tolerance), CX-202 (81.y.o. retiree, "moderate" risk tolerance); CX-204 (47-y.o. single mother, "aggressive,"), CX-206 (77-y.o. widow, almost no investment experience, "moderate,"), CX-209 (55-y.o. single mother, "moderate,"), CX-227 (38-y.o. administrative assistant with almost no investment experience, "aggressive")

[187] CX-237.

safeguarding of customer information. Brookstone also failed to provide customers with the opportunity to opt out of this information-sharing arrangement.

Brookstone, acting through Turbeville and Locy, failed to enforce its written procedures, which required that customer information be safeguarded. Although Turbeville and Locy knew that confidential customer information was being transmitted over the Internet through non-secured, web-based e-mail accounts, they took no steps to ensure that customer information was protected.

2. Conclusions of Law

NASD Conduct Rule 3010(b) requires that each member establish, maintain and enforce written procedures to supervise the types of business in which it engages in order to achieve compliance with applicable securities laws and regulations and with applicable NASD Rules. Brookstone, acting through Locy, failed to adequately supervise customer CMO accounts and transactions. Locy failed to respond to red flags indicating that the CMO investments at issue in this matter were unsuitable for certain customers and failed to take any other meaningful steps to ensure that the CMO investments were suitable for the customers.

The Hearing Panel found by a preponderance of the evidence that Brookstone, Turbeville, and Locy violated Rules 3010 and 2110.

IV. SANCTIONS

A. Violations of § 10(b) of the Exchange Act, Rule 10b-5 thereunder, and Rules 2120 and 2110 by Making Fraudulent Misrepresentations and Omissions

For intentionally making misrepresentations or omissions of material facts, the FINRA Sanction Guidelines ("Guidelines") recommend that individuals and firms be fined between $10,000 and $100,000, and in egregious cases, suspended, barred or expelled. The Guideline specifically directs adjudicators to General Principle No. 6, which states that adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial gain.[188]

1. Brookstone

The Hearing Panel finds that Brookstone's violation was egregious and without mitigation. Brookstone is responsible for Turbeville's and Kline's fraudulent misrepresentations and omissions regarding the risks associated with investing in CMOs and Brookstone's CMO strategy generally. The Hearing Panel reviewed and found several aggravating factors relevant to this proceeding.[189] Brookstone's disciplinary history "evidences disregard for regulatory requirements."[190] The firm neither acknowledged nor accepted responsibility for the misconduct at issue in this matter.[191] Instead, through Turbeville and Kline, it attempted to blame the customers for their own losses. The customers who were harmed by Brookstone's conduct were elderly, retired and financially unsophisticated. In total, during the two-year Relevant Period, Brookstone earned approximately $492,500, in commissions (markups/markdowns) on CMO bond transactions from seven customers named in the Complaint. During the same period, those seven customers lost $1,620,100.[192] The Panel found that Brookstone's conduct was intentional.[193] For this egregious violation, Brookstone is censured and fined $500,000.

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[188] FINRA Sanction Guidelines at 88 (2011 ed.), www.finra.org/sanctionguidelines.

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

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

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

[192] CX-357A, 358A, 359A, 360A, 362A, 363A, 364A. Figures for LD have been excluded.

[193] Guidelines at 7 (Principal Consideration No. 13).

2. Turbeville

Turbeville intentionally made multiple misrepresentations and withheld material facts from his customers regarding the characteristics and risks associated with CMOs, the implementation of Brookstone's CMO strategy, and the use of margin to invest in CMOs. He made these fraudulent misrepresentations and omissions to enrich himself—initially to lure his customers to purchase CMOs, and later to induce them to allow him to continue trading their accounts. He preyed on their greatest fears—losing their assets to nursing homes and becoming destitute during their retirement and old age. All of the factors that aggravate Brookstone's conduct also apply to Turbeville. The Hearing Panel found that Turbeville's violation is egregious and found no mitigating factors. He is therefore barred from associating with any FINRA-regulated firm in any capacity.

3. Kline

Like Turbeville, Kline made multiple misrepresentations and withheld material facts from his customers regarding the characteristics and risks associated with CMOs, the implementation of Brookstone's CMO strategy, and the use of margin to invest in CMOs. Two of his elderly customers were widows who had relied completely on their husbands to handle their finances. Vulnerable after their husbands' deaths, they turned to Kline, who invested their savings in risky CMOs, and increased their risk by trading on margin. Kline's customers lost even more money than Turbeville's. All of the factors that aggravate Turbeville's and Brookstone's conduct apply equally to Kline. Kline's conduct was egregious, and the only way to protect the investing public from similar conduct in the future is to bar him from associating in any capacity with any FINRA-regulated firm.

B. Violations of Rules 2310(a) and 2110 by Making Unsuitable Recommendations to Customers

For making unsuitable recommendations, the Guidelines recommend that individuals and firms be fined between $10,000 and $75,000, and in egregious cases, a firm's suspension for up to two years, and an individual's suspension or bar. The Guideline specifically directs adjudicators to General Principle No. 6, which states that adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial gain.[194]

1. Brookstone

Turbeville and Kline recommended scores of unsuitable CMO transactions to their seven customers between July 2005 and July 2007. They took advantage of the trust placed in them by those customers—all of whom were retired, many of whom were elderly, and none of whom was a sophisticated investor. They trusted Turbeville and Kline to ensure that their life savings would sustain them throughout retirement. Turbeville and Kline took advantage of this trust to enrich themselves, and did so without any reasonable basis for believing that inverse floaters or other CMOs were suitable for these customers.

Brookstone is responsible for the egregious suitability violations committed by Turbeville and Kline. For this violation Brookstone is fined $300,000.

2. Turbeville

The Hearing Panel found Turbeville's conduct to be egregious and found no mitigating factors. He is therefore barred from associating with any FINRA-regulated firm in any capacity.

[194] Guidelines at 95.

3. Kline

The Hearing Panel found Kline's conduct to be egregious and found no mitigating factors. He is therefore barred from associating with any FINRA-regulated firm in any capacity.

C. Violations of Rules 2210(d)(1)(A) and 2210(d)(1)(B) by Sending Misleading Letters to Customers

For intentional use of misleading communications, in violation of Rule 2210, the Sanction Guidelines recommend a fine of $10,000 and $100,000 and a suspension of a firm or individual in any or all capacities for up to two years.[195]

1. Brookstone

Brookstone is responsible for Turbeville's dissemination of intentionally misleading letters to his customers in an effort to keep them at the firm in Brookstone's CMO trading program. For this violation, Brookstone is fined $50,000.

2. Turbeville

For this violation, the Hearing Panel would have imposed a significant fine against Turbeville. In light of his bars, however, a fine would serve no remedial purpose and will not be imposed.

D. Violations of Rules 2510(c) and 2110 by Failing to Review Discretionary Accounts

For failure to supervise, the Guidelines recommend a fine of $5,000 to $50,000. In egregious cases, the Guidelines recommend a suspension of up to two years for the responsible individual. The Guideline specifically directs adjudicators to General Principle No. 6, which states that adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial gain.[196]

[195] Guidelines at 80.

[196] Guidelines at 103.

1. Brookstone

Brookstone, through Locy, failed to conduct any meaningful supervision of discretionary accounts as required by Rule 2510(c). He also failed to take action in response to several red flags indicating that there were problems with the accounts. For this violation, Brookstone is fined $50,000.

2. Locy

Locy completely ignored his responsibility as chief compliance officer to review the discretionary accounts of Brookstone customers. His conduct was egregious because he looked the other way while Turbeville and Kline traded CMO accounts that were unsuitable for their customers. For this violation, Locy is barred from acting in any supervisory or principal capacity for any FINRA-regulated firm.

E. Violations of Rules 3010(b) and 2110 by Failing to Adequately Supervise Customer CMO Accounts and Transactions

For failure to supervise, the Guidelines recommend a fine of $5,000 to $50,000. In egregious cases, the Guidelines recommend a suspension of up to two years for the responsible individual. The Guideline specifically directs adjudicators to General Principle No. 6, which states that adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial gain.[197]

[197] Guidelines at 95.

1. Brookstone

Brookstone is responsible for its and Locy's complete failure to supervise Turbeville and Kline with respect to the CMO transactions and discretionary accounts at issue in this matter. Brookstone also failed to enforce its own written supervisory procedures regarding safeguarding customer information. Both of these violations are serious and caused significant customer harm. Furthermore, it indicates Brookstone's systemic disregard for both its customers and the standards of the securities industry. As such, Brookstone's failure to supervise was egregious. The Hearing Panel finds that a fine of $100,000 is appropriate.

2. Turbeville

As a principal of Brookstone, and someone with supervisory responsibility over Kline and Locy, Turbeville is also responsible for failing to supervise Brookstone's CMO program and its brokers. The Hearing Panel would have suspended and fined Turbeville for this violation; however, in light of his bars, additional sanctions would serve no remedial purpose and will therefore not be imposed.

3. Locy

Locy should have been a line of defense against Turbeville's and Kline's egregious conduct; however, he completely abdicated his responsibility to supervise them. Serving merely to "rubber stamp" their new accounts, Locy did not conduct even the most basic review of Brookstone's CMO program. He was almost as culpable as they are for the customer harm that occurred. The Hearing Panel finds that he should be barred from acting in a supervisory or principal capacity with any FINRA-regulated firm, suspended from associating in any capacity with any FINRA-regulated firm for two years, and fined $25,000.

F. Restitution

The Sanction Guidelines provide that restitution may be ordered "when an identifiable person … has suffered a quantifiable loss as a result of a respondent's misconduct, particularly where a respondent has benefitted from the misconduct."[198] Restitution of customer losses in this situation is necessary to remediate the harm done by the unsuitable recommendations of Brookstone's representatives and the firm's failure to detect and prevent those recommendations.

The evidence shows that, collectively, the customers suffered losses totaling at least $1,620,100 as a direct result of the unsuitable CMO transactions recommended by Brookstone, Kline and Turbeville during the period from July 2005 and July 2007. The customers trusted Brookstone, Turbeville and Kline to act in their best interests. It would be manifestly unjust for the customers to bear the losses resulting from Respondents' misconduct, while permitting Respondents to enjoy the spoils of their actions.

Therefore, the Hearing Panel orders Brookstone to make full restitution to the seven customers listed in the Restitution Chart below. Turbeville and Kline are ordered to pay restitution, jointly and severally with Brookstone, to their respective customers. During the hearing, the Respondents revealed that they had entered into settlements with a few of the customers in this matter on the eve of the hearing (or during the hearing in at least one instance). The Hearing Panel will order that full restitution be paid to each customer, with such restitution offset by any amounts Respondents can prove that they have already paid to a particular customer.

[198] Guidelines at 4.

<u>Restitution Chart</u>[199]

<u>Brookstone and Turbeville:</u>	$414, 800 to MR $22,100 to BC	$3,700 to BB
<u>Brookstone and Kline:</u>	$342,100 to JG $551,800 to CP	$26,800 to SB $258,800 to Estate of HP

V. ORDER

In summary, Brookstone is censured and fined $1,000,000; Turbeville is barred in all capacities; Kline is barred in all capacities; and Locy is barred from acting in a supervisory or principal capacity, suspended in all capacities for two years, and fined $25,000. Brookstone, Turbeville and Kline are also ordered, jointly and severally, to pay restitution to customers in amounts totaling $1,620,100. The details of these sanctions are as follows:

For violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Rules 2120 and 2110, by making fraudulent misrepresentations and omissions of material fact in selling CMOs to unsophisticated, elderly, and retired investors, Brookstone is censured and fined $500,000, and Turbeville and Kline are barred from associating in any capacity with any FINRA-regulated firm.

The Second Cause of Action, which alleged, in the alternative, that Brookstone, Turbeville, and Kline acted negligently, was subsumed within the fraud charge.

For violating Rules 2310(a) and 2110 by making unsuitable recommendations of CMOs, Brookstone is fined $300,000, and Turbeville and Kline are barred from associating in any capacity with any FINRA-regulated firm.

[199] The data contained in this chart is taken from CX-357A, CX-358A, CX-359A, CX-360A, CX-362A, CX-363A, and CX-364A. See also, Tr. 3378-82, 3395-97, 3407-08, 3415-22, 3428-40.

For violating advertising Rules 2210(d)(1)(A) and 2210(d)(1)(B) by making misrepresentations, omitting material facts, and using misleading statements in letters to customers, Brookstone is fined $50,000.

For violating Rules 2510(b) and 2110 by failing to review customer discretionary accounts, Brookstone is fined $50,000, and Locy is barred from acting in any supervisory or principal capacity with any FINRA-regulated firm.

For violating Rules 3010(b) and 2110 by failing to adequately supervise customers' CMO accounts and transactions, and by failing to safeguard customer information, Brookstone is fined $100,000. Locy was barred from acting in any supervisory or principal capacity with any FINRA-regulated firm, suspended from associating with any FINRA-regulated firm in any capacity for two years, and fined $25,000. Because of the bar against Turbeville, the fines are not imposed against him.

Brookstone is ordered to pay restitution to the customers listed in the Restitution Chart above, in the amount of $1,620,100, with $440,600 of that amount imposed jointly and severally with Turbeville, and the remaining $1,179,500 imposed jointly and severally with Kline.

All of the Respondents are also ordered to pay, jointly and severally, costs in the amount of $27,047.55, which includes a $750.00 administrative fee and the cost of the hearing transcript. The fines and costs shall be payable on a date set by FINRA, but not less than 30 days after this Decision becomes FINRA's final disciplinary action in this matter. If this Decision becomes FINRA's final disciplinary action in this matter, Locy's suspension will begin on August 6, 2012, and end on August 5, 2014. He is ordered to pay his fine if and when he becomes re-registered with FINRA.[200]

SO ORDERED.

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Rochelle S. Hall
Hearing Officer
For the Extended Hearing Panel

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