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# FINANCIAL INDUSTRY REGULATORY AUTHORITY
# OFFICE OF HEARING OFFICERS

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| DEPARTMENT OF ENFORCEMENT,<br><br>Complainant,<br><br>v.<br><br><br><br>Respondent. | Disciplinary Proceeding<br>No. 2008013863702<br><br>Hearing Officer – LBB<br><br>**EXTENDED HEARING PANEL DECISION**<br><br>August 28, 2012 |

**The Extended Hearing Panel dismisses charges that Respondent made material omissions to eight corporate clients, and exercised discretion in their accounts without obtaining written authorization from the clients or written acceptance of the accounts as discretionary from his member firm.**

*Appearances*

Gary A. Carleton, Esq., Senior Counsel, and Daniel A. Cantu, Esq., Senior Counsel, Rockville, Maryland, for the Department of Enforcement.

David Spears, Esq., Jason Mogel, Esq., and Monica P. Folch, Esq., Spears & Imes LLP, New York, New York, for Respondent.

## DECISION

The Department of Enforcement ("Enforcement") filed the Complaint in this disciplinary proceeding on April 14, 2010, against [Respondent], asserting three causes of action relating to the purchase and sale of auction rate securities ("ARS") in the accounts of eight corporate clients. The First Cause of Action charges Respondent with material omissions in the sale of ARS to the eight corporate clients, in violation of NASD Rule 2110. The Second Cause of Action charges Respondent with violating NASD Rule 2110 by failing to disclose to "Company P," one of the eight corporate clients, in late 2007 and early 2008 that the market for ARS was "under stress or otherwise in trouble." The Third Cause of Action charges Respondent with violating NASD Rules 2510 and 2110 by failing to obtain written authorization from the eight clients for the exercise of discretion, and failing to obtain written acceptance of the accounts as discretionary from his firm.[1]

A nine-day hearing was conducted in New York City before an extended hearing panel composed of a current member of the District 11 Committee, a former member of the District 10 Committee, and a Hearing Officer. The witnesses included Respondent; one expert for Enforcement and two for Respondent; the compliance officer who was responsible for Respondent's group; two witnesses from Company P; industry witnesses from other broker dealers; witnesses from Respondent's firm; one character witness; and a FINRA investigator.

The parties submitted post-hearing briefs on February 29, 2012, and March 16, 2012.

## Summary of Findings and Conclusions

Respondent was a member of the Corporate Cash Management Group ("CCM") at member firm [the "Firm"]. CCM managed the cash needs of corporate clients by investing in safe and liquid investments. There were three members of CCM–Respondent, ["AR"], and ["RD"]. Respondent and AR were primarily responsible for soliciting potential clients and working with clients to structure portfolios. RD's primary focus was the day-to-day management of accounts, including investing client funds and placing purchase and sale orders on behalf of CCM clients. Respondent did not select ARS for clients or execute trades.

CCM's clients were sophisticated companies, but some did not have the infrastructure to manage their own accounts, and asked CCM to manage their cash needs. For these clients, CCM

[1] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). This decision relies on NASD Rules 2510 and 2110, which were the applicable rules at the time of Respondent's alleged misconduct. The applicable rules are available at www.finra.org/rules.

exercised limited discretion by selecting investments and making the decisions on when to buy and sell, subject to investment guidelines provided to CCM by the clients.[2] This proceeding involves only the eight companies for which CCM exercised limited discretion in providing cash management services from August 2007 until February 2008. Of those eight companies, only three were Respondent's clients. The other five were clients of another CCM representative, but Enforcement contends that Respondent had a duty to make disclosures to all eight limited discretion clients because of the close working relationship among the members of the CCM team.

CCM invested in ARS on behalf of the eight clients because ARS were safe and liquid investments with higher yields than other potential investments such as U.S. Treasury securities, and fit within the clients' investment guidelines. CCM bought and sold ARS for its clients in four ways: 1) at auction; 2) in cross trades; 3) in new issue purchases; and 4) from the inventories of the broker-dealers that underwrote the ARS.

CCM did not charge its clients for transactions or services. It received most of its compensation from issuers as trailing commissions on the ARS in its clients' accounts. When CCM bought new issue ARS, it typically received additional compensation from the underwriters in the form of discounts on the price of the ARS. CCM received a share of the discounts from the Firm as additional compensation for the members of the group.

The First Cause of Action charges Respondent with failure to disclose to the eight clients that CCM was purchasing new issue securities and receiving discounts from the underwriting broker-dealers, compensation that was not available for purchases of ARS that were already on

[2] In this decision, the clients that selected their own investments are called "self-directed" clients, and those that relied on CCM to make their investments are called "limited discretion" clients, the terms generally used by Respondent and the witnesses from the Firm who testified.

the market. In dismissing this charge, the Extended Hearing Panel finds that Respondent disclosed to his clients that CCM would purchase new issue securities and receive additional compensation. Further, even if he had not made these disclosures, the Extended Hearing Panel finds for several reasons that the information was not material, including that the new issue securities satisfied the clients' investment guidelines, any arguable difference in the yield would be quickly eliminated at the next auction, and CCM could not share the new issue discount with the clients. The Extended Hearing Panel also dismisses the charge that Respondent failed to disclose the availability of ARS that were "comparable or similar" to the new issue purchases but with a higher yield. Enforcement failed to consider a number of factors that could reasonably be used as a basis for selection of ARS and might affect their yield, and therefore has not shown that there were comparable or similar ARS with a higher yield.

The First Cause of Action also charges Respondent with failure to disclose that CCM was engaging in cross trades among the clients' accounts. The Extended Hearing Panel dismisses this charge because it finds that the use of cross trades in client accounts was not material information, and actually benefited CCM's clients. The Complaint also charges that Respondent failed to disclose that rather than engaging in cross trades of ARS, CCM could have bought comparable ARS with higher yields for clients that were the buyers of the securities in cross trades. The Extended Hearing Panel also dismisses this charge, for reasons similar to those considered in dismissing the similar charge with respect to new issue purchases.

The Second Cause of Action relates only to a single limited discretion client, Company P. Enforcement charges that Respondent failed to disclose to Company P that the ARS market was "under stress or otherwise in trouble" between August 2007 and February 2008, when the ARS market froze. The Extended Hearing Panel dismisses this cause of action because Respondent did not believe that the market was in trouble during that time, and was not negligent in failing to conclude and warn clients that market was "under stress" or "in trouble." In fact, the ARS market collapse was catastrophic for the market as a whole precisely because it was unforeseen by the sophisticated investors who had $330 billion invested in ARS at the time the ARS market collapsed in February 2008.

Finally, the Extended Hearing Panel dismisses the Third Cause of Action, charging Respondent with exercising discretion in the eight limited discretion accounts without written authorization from the clients or written approval from his firm. CCM traded for these clients pursuant to the clients' investment guidelines, which limited the types of permissible investments. The Firm was fully aware of and approved CCM's practice of trading in these accounts without written authorization, which was consistent with industry practice. Under these facts, the majority of the Extended Hearing Panel finds that FINRA's rules did not require CCM to obtain a written grant of discretion from the clients or written approval from the Firm.[3]

## Background Facts

### I. Respondent

Respondent has been registered with FINRA since 1992. CX-2; Stip. 1.[4] He first traded ARS in about February 1995, while at [Member Firm D], executing transactions for the clients of that firm's financial advisors. Tr. 94-95. He joined the Firm in February 2003 as a managing director of the newly-established CCM, where he continues to work. CX-2; Stip. 4. At the time of the events in the Complaint, he was registered as a General Securities Representative, General Securities Principal, and Municipal Securities Principal. He continues to maintain those registrations today. Stip. 4; CX-2.

[3] The Hearing Officer does not join in this finding.

[4] The parties filed a set of stipulations on November 20, 2011.

## II. The Corporate Cash Management Group

Respondent and AR founded CCM in 2003. Stip. 5. RD joined CCM in 2004. Stip. 6. From 2006 through 2008, CCM operated within the Private Client Services Division. Stip. 8. CCM managed cash and short-term investments on behalf of companies seeking safe and liquid investments. Tr. 156-157, 318; CX-17. Respondent and AR were primarily responsible for soliciting potential clients and working with clients to structure portfolios. Stip.10. RD's primary focus was the day-to-day management of accounts, including investing client funds and placing purchase and sale orders on behalf of CCM clients. Stip. 11; Tr. 521. Respondent did not supervise the other members of CCM. Tr. 108-109, 437.

CCM served approximately 40 corporate clients. Stip. 9. The group served both self-directed and discretionary clients, although this matter involves only the limited discretion clients. Most of CCM's customers were self-directed, making all investment decisions for themselves and using CCM to execute orders. Tr. 154, 375, 1067-1069. CCM's clients typically had three goals: 1) preservation of capital; 2) liquidity; and 3) returns. Tr. 314. CCM did not charge commissions or other fees to its clients. For ARS transactions, CCM was compensated primarily from trailing commissions from the issuers. For most ARS transactions, CCM's only revenue was trailing commissions. Tr. 130, 1273; CX-27 at 7. In addition, as discussed below, CCM received discounts on the purchase of new issue ARS from the broker-dealers that underwrote the new issues.

## III. CCM's Eight Limited Discretion Accounts

When CCM started at the Firm, some clients asked the group to manage their portfolios according to investment guidelines. For them, CCM received oral approval from the clients to manage the accounts as limited discretion accounts, but did not receive written approval. ["BA"], who was the administrative head and compliance supervisor of the Private Client

Services Division (Tr. 101), approved the practice of servicing limited discretion clients according to investment guidelines approved by the clients, without receiving written authorization from the clients. When ["RF"] became CCM's compliance officer and supervisor, he also approved the practice. Tr. 248-249, 268, 375, 424, 1237-1244.

Enforcement contends that Respondent's duties under FINRA's rules extend to all eight limited discretion clients because CCM acted as a team. Only Company P and two other limited discretion clients, Company I and Company E, were Respondent's clients. Company I was more involved than the typical client in the selection of ARS and discussing the market with RD, although he selected ARS for that client. Tr. 570-571, 616, 1077.

CCM's limited discretion clients were sophisticated companies. All had chief financial officers who had experience with financial services and transactions. Tr. 1067-1068, 2515-2516. The average size of the limited discretion clients' accounts was about $75 million. Tr. 2516.

CCM managed limited discretion clients' investments according to the clients' investment guidelines. Tr. 157, 197-200, 245, 256. The guidelines were created or approved by the clients. Tr. 198-199, 1970. When Respondent received guidelines from his clients, he discussed suitable investments with them. Tr. 206. Within the guidelines, RD made investment decisions, buying and selling without input from CCM's limited discretion clients, typically without discussing his selections with Respondent or AR. Tr. 145, 252-253, 942.

RD considered a long list of factors in selecting ARS for CCM's limited discretion clients. Tr. 577-578.[5] Yield was an important factor, but often not the most important, and RD did not always select the ARS with the highest yield. Tr. 955. RD decided whether CCM would execute transactions through auctions, cross trades, purchases from dealers' inventories, or new issue purchases. Tr. 256. The only limitation was that all investments had to fall within each client's investment guidelines. Tr. 257.

As CCM's compliance officer and supervisor, RF knew CCM traded on behalf of clients without written authorization, and executed trades for those clients without contacting the client prior to trades. Tr. 873, 905. RF did not tell CCM to change its practices. Tr. 908.

## IV. Auction Rate Securities

### A. The Auction Rate Securities Market

The ARS market began in 1984, and by 2008 it had grown into a $330 billion market. CX-166. ARS are long-term securities with interest rates that reset periodically through a "Dutch auction" process. Before February 2008, auctions provided the primary source of liquidity for ARS investors and typically occurred every 7, 14, 28, or 35 days. Stip. 12; CX-166; RX-84.

Auctions were usually managed by the underwriter for the issuer. In an auction, potential buyers entered bids to buy ARS at the minimum interest rate each would accept. Existing holders could submit an order to hold the ARS an investor already owned, at a minimum acceptable rate; an order to continue to hold at whatever rate was set at the auction; or an order to

[5] Among the factors RD considered in selecting ARS were the type of auction rate security; the issuer; credit quality; the interest rate; the underlying broker-dealer supporting the auction; interest payment frequency; the calendar basis for computing the interest payments (whether it would be computed for a 360 or 365 day period); the client's current holdings; the client's perceived or known expected liquidity needs; credit ratings; the number of rating agencies; the revenue source behind the issuer (e.g., if it was a revenue bond, like a toll road, or a general obligation of the issuer, like New York State general obligation); credit enhancements, such as insurance; and the underlying credit ratings without regard to credit enhancement. Tr. 577-578. Enforcement's expert did not consider several of these factors in determining the availability of "comparable" or "similar" ARS, as discussed below.

sell. CX-166 at 3; RX-84; Tr. 2199. The Firm was a "downstream" firm in the ARS market, i.e., it functioned in a traditional broker role as agent for its clients and placed bids with auction dealers on behalf of customers to purchase and sell ARS. Stip. 13.

### B. Risks of ARS

The two most significant risks of investing in ARS were credit risk (default by an issuer) and auction failure (or liquidity risk). CX-166 at 4; Tr. 455. The Second Cause of Action relates to an alleged increase in liquidity risk in the months before the ARS market froze in February 2008.

An auction could fail if the supply of ARS offered by sellers exceeded the demand for ARS by buyers. Until February 2008, the vast majority of auctions were successful. To avoid failed auctions, underwriting broker-dealers would submit "support bids," which were bids sufficient to clear the market. Tr. 2201-2202, 2445; CX-166 at 3; RX-84, RX-112.

When auctions failed, investors continued to receive interest payments from issuers at a default or maximum rate specified in the offering documents. For certain types of ARS, especially those involving student loans, the maximum rate was typically a fixed spread over a specified index, often the LIBOR.[6] Other ARS had fixed maximum rates. RX-84; CX-166; Tr. 1664-1669.

## V. Other Methods of Buying and Selling ARS for CCM's Limited Discretion Clients

In addition to buying and selling at auction, CCM also traded ARS on behalf of its limited discretion clients by buying them from an underwriting broker-dealer's inventory, cross trading with other limited discretion clients, or buying new issue ARS. Tr. 227.

[6] LIBOR refers to the London Interbank Offered Rate.

### A. Purchases from the Inventories of Underwriting Brokers

CCM received lists that underwriting broker-dealers sent to downstream brokers, identifying the ARS the underwriters had in inventory that were available for sale between auctions. Tr. 212, 524-525, 998. The lists were extensive, sometimes offering hundreds of ARS. Tr. 216; *see*, e.g., CX-30.

RD, the CCM member who was primarily responsible for ARS trading, and AR, who occasionally traded ARS for clients, reviewed the lists and exercised their judgment to cull them substantially to create daily offering lists that CCM sent to its self-directed clients. Tr. 213-218, 526-529, 1105, 1139; CX-31. Although CCM did not send the lists to limited discretion clients, RD used the lists, as well as the inventories received from the underwriting broker-dealers, as one source of ARS he selected for clients. Tr. 530-531.[7]

### B. New Issue Purchases

CCM sometimes bought new issue ARS from underwriting broker-dealers, but they were a small fraction of RD's total ARS purchases.[8] As compensation for their underwriting efforts, underwriting broker-dealers received discounts on ARS from the issuers and often shared the discounts with downstream brokers like the Firm. Tr. 377, 943, 2424-2425. When CCM bought new issues for its clients, the Firm typically received a discount from the underwriter and sold the new issues to clients at par, resulting in additional compensation for the Firm and CCM.

[7] Enforcement's expert used these lists to identify ARS that he considered comparable or similar to new issue and cross-traded ARS, in support of Enforcement's contention that Respondent should have disclosed to clients that CCM could have selected comparable or similar ARS with higher yields.

[8] Enforcement states in its post-hearing brief that 13% of CCM's purchases of ARS during the period were new issue ARS, accounting for 27% of the group's revenue. *See* Department of Enforcement's Post-Hearing Brief at 30. In its reply brief, Enforcement asserts that about 25% were new issue ARS. *See* Department of Enforcement's Reply Brief at 7, n.16.

Tr. 383-384, 625.[9] The additional compensation for new issue ARS typically ranged from $0.50 to $1.50 per bond, although occasionally there was less compensation, or no additional compensation. Tr. 134-136, 593-594.[10] For the purchases challenged by Enforcement, new issue compensation ranged from $1,200 to $15,000. CX-166 at 7.[11] RF, the compliance officer responsible for CCM, knew that CCM was purchasing new issue securities. Tr. 411, 908-909, 933.

Respondent believed that the purchase of new issues was advantageous for clients because new issues provided diversity to their portfolios. Tr. 378. He also believed that new issues sometimes provided "scarcity value," which he regarded as beneficial for clients, but could result in lower yields.[12] Tr. 379-381. In selecting new issues, CCM, primarily RD, considered a number of factors, including the issuer, collateral, credit enhancement, issuer location or domicile, credit ratings, underlying credit ratings, reset frequency, payment frequency, reset day of the week, and tax status. Tr. 378. CCM regarded other attributes, such as diversification, as more important than yield for new issues. Tr. 386, 586-587. The compensation the Firm received on new issue purchases was not a factor in CCM's decision to purchase new issues. Tr. 943.

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[9] Respondent believed that the Firm could not share the underwriting discounts on new issues with its customers, and that all ARS had to be sold at the same price, typically at par. He testified that those customers who bought directly from underwriters also could not receive part of the underwriting discount, so customers paid the same price for new issues whether they bought from the Firm or directly from the underwriting broker-dealers. Tr. 383-384. Respondent did not explain whether his view was based on restrictions by the underwriters or issuers, the Firm's policies, or his understanding of the applicable law and rules.

[10] As an illustration, for a $10 million purchase, the discount to the Firm would have been about $10,000. CCM's share of the $10,000 would be $4,000. Tr. 947-948.

[11] Then Firm received trailing commissions on all ARS sales. The Firm received trailing fees of approximately 3.5 to 15 basis points for ARS debt, and up to 25 basis points on auction rate preferred securities. Tr. 130, 776.

[12] Respondent explained that "scarcity value" meant that a security was more valuable because it was less available than other securities. He testified that it is a common concept in the fixed income marketplace. For the CCM limited discretion clients, Respondent said buying ARS with scarcity value was advantageous because it added diversification. Tr. 380, 384-386.

In initial presentations, Respondent told his limited discretion clients that he would buy new issues, that all fees for new issue purchases would be paid by the issuers, and that he would receive a higher commission on new issues. Tr. 387-388, 401-402, 405-406; RX-68 at 7.[13] He believed, incorrectly, that clients would learn of new issue purchases when they received prospectuses from the Firm. Tr. 256, 388, 913-914, 1080, 1082.[14] At least some CCM clients and potential clients received a brochure that stated, "For new issue and auction rate securities, the brokerage firm is paid directly by the issuer." RX-68 at 7; CX-27 at 7. Respondent did not discuss the discount in advance of individual new issue purchases. Tr. 405. The new issue purchases were executed as riskless principal transactions, and disclosed on trade confirmations as principal transactions. Tr. 1976, 2127; RX-94.

Enforcement's expert, ["JD"], testified that industry practice was to disclose new issue purchases before trades were made. Tr. 1763.[15] However, JD's view is inconsistent with his testimony that purchases of new issues were generally prohibited for discretionary accounts, because there would be no purchases for which to make disclosures if the purchases were prohibited. It is also inconsistent with his testimony that new issues offered lower yield to investors than comparable ARS, because investors would not buy the new issues if they could

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[13] Respondent's hearing testimony that he told clients about the Firm's receipt of new issue discounts appeared to contradict his testimony at his OTR, when he testified that when meeting with clients, he did not think the Firm's new issue compensation was "something that [he] had to disclose to the client." He explained the apparent inconsistency by saying that he did not disclose new issue compensation before every purchase. Tr. 404-405. The Extended Hearing Panel found his testimony at the hearing credible despite this apparent contradiction because he appeared to be careful and truthful in his answers, and because it was reasonable that the disclosure would have been made in the context of an overall presentation to a new client. *See* Tr. 405-406.

[14] Respondent learned later that the Firm did not always send prospectuses to clients in connection with new issue ARS purchases. Tr. 389.

[15] Industry practice may be relevant to determining whether disclosure was required, but is not determinative. The SEC recently noted that "compliance with the industry standard is only one factor, not the controlling factor, to be weighed in determining the standard of care for a particular regulation." *Midas Sec. LLC*, Exchange Act Rel. No. 66200, 2012 SEC LEXIS 199, at *44-45 (Jan. 12, 2012); *see also Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004) (citing *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 857 (9th Cir. 2001)); *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 274 (3d Cir. 1998) (noting that "a universal industry practice may still be fraudulent").

obtain higher yields on comparable securities. Tr. 1762, 1815; CX-166 at 7.[16] ["BU"], Respondent's expert, took the opposite view on industry practice. RX-148 at 13. BU was more credible in general and on this point. The Extended Hearing Panel finds that it was not industry practice to disclose new issue purchases to corporate cash management clients.

### C. Cross Trades Among CCM's Limited Discretion Clients

Between August 2007 and February 2008, CCM executed 39 cross trades for limited discretion customers. Enforcement contends that CCM and Respondent failed to disclose the practice of cross trading to its limited discretion clients, and that the information was material. In addition, Enforcement challenges 32 of the cross trades, arguing that CCM could have bought "comparable" or "similar" ARS with higher yields from the inventories of underwriting broker-dealers. Tr. 2082-2085; CX-166, CX-171.

CCM generally employed two methods of providing liquidity to clients between auctions. CCM would sometimes provide liquidity by buying ARS from clients. The Firm made $15 million available to CCM for this purpose in the event the group needed to provide liquidity for clients between auction dates. Tr. 417-418, 2514. More often, CCM executed cross trades among limited discretion clients. Tr. 1097, 1100. There was no secondary market for ARS, so CCM could not provide liquidity by selling ARS to non-clients between auctions. Tr. 417. Cross trades were executed without notifying the two participating clients that the trade had been

[16] Both experts are well qualified to testify. JD is a securities litigation consultant who has been retained and testified in a substantial number of securities litigations. He also has substantial experience as a broker. CX-166. BU is a litigation and compliance consultant who was chief compliance officer at Firm A and Firm W from 1989 to 2008. He advised Firm A business units on the establishment of its corporate cash management program, including its policies and procedures. He has substantial experience in working with securities organizations on issues relating to compliance. He has served on many committees and working groups, working with regulatory bodies, exchanges, self-regulatory bodies (including FINRA), and the financial services industry. BU is an attorney, and held several securities licenses before he retired from Firm W. Tr. 2369-2382; RX-148. The Extended Hearing Panel found BU to be more credible. JD appeared to be an advocate for Enforcement's position, often answering simple questions with arguments about why his overall conclusions were correct without addressing the specific questions. Although BU supported Respondent's positions, he was more candid and direct in his answers.

a cross trade. Tr. 255-256, 414. Cross trades were executed as riskless principal transactions, with the Firm buying the ARS from one limited discretion client and immediately selling the ARS to the purchasing limited discretion client. Tr. 2283. Trade confirmations identified cross trades as principal transactions. *See*, e.g., RX-93.

CCM engaged in cross trading primarily to provide liquidity to clients when holders of ARS requested liquidity between auctions. Tr. 415, 565, 568-569. RD sometimes executed cross trades to rebalance a client's portfolio. Tr. 576. The Firm did not receive compensation for cross trades. Tr. 417, 952-953. RF was aware that CCM did cross trades for clients, and did not think it was improper. Tr. 912-913, 933.

JD, Enforcement's expert, testified that industry practice is to disclose cross trades to customers. Tr. 1764. BU, on the other hand, testified that it is common industry practice to process and disclose cross trades as riskless principal transactions. Tr. 2436-2437; RX-93. BU testified that cross trades are common in corporate cash management, particularly for ARS, and that cross trades are offered by brokers as a featured service to clients, as a means of providing liquidity between auctions. Tr. 2434-2435. The Extended Hearing Panel found BU's testimony more persuasive, and finds that his testimony on these points accurately states industry practice.

## VI. Company P

### A. Establishment of the Relationship and the Grant of Limited Discretion

The Second Cause of Action charges Respondent with failure to disclose to Company P that the ARS market was "under stress or otherwise in trouble" from August 2007 until the ARS auction market collapsed in February 2008. Company P was a Firm investment banking client. The Firm raised $160 million for Company P in a debt offering in 2006, and invested an additional $50 million in the company. The Firm sold most of its equity interest, but retained

$7-8 million. Tr. 269-270, 283, 1357, 1542-1543. The Firm thus had a substantial stake in Company P's success.

Company P was a sophisticated customer. One of Respondent's principal contacts at the company was S.G., an officer of the company who was initially responsible for helping the company raise money. She has an undergraduate degree in management, accounting, and finance, an M.B.A. in management and finance, a French accounting license, and experience as a financial analyst. Tr. 1345-1346, 1348; RX-58 at 54. S.G. had no experience with ARS prior to meeting with Respondent. Tr. 348. C.S., another of Respondent's principal contacts, had "20 years of experience as a seasoned finance and insurance executive and has been the Executive Vice President and Chief Financial Officer of [Company P] since 2001." RX-58 at 53. C.S. also had no experience with ARS prior to meeting with Respondent. Tr. 943. P.F., Company P's president and chief executive officer, has engineering degrees and an M.B.A., and years of business experience, including experience in starting businesses. Tr. 1536-1537; RX-58. R.M., an accountant who had been a CFO in previous employment, became controller in September 2006. P.F. (not the same "P.F." as the company's president), who became the CFO early in 2007, has an MBA, and had experience with a similar company. Tr. 1532-1533, 1607, 1609. S.G. and P.F. (the president and CEO) testified at the hearing.

In September 2006, as part of its financing, Company P entered into the Proceeds Escrow Agreement, which had provisions on the management of the funds that the Firm helped Company P to raise. The escrow agreement permitted Company P to invest the funds in six categories of conservative and liquid investments, including ARS. CX-115. The initial amount in escrow was $187,700,000. CX-115.

Respondent met with S.G. and C.S. to discuss specific corporate cash management strategies on October 2, 2006. He discussed various types of potential investments, including ARS. Tr. 347-348, 395-396, 1365-1367. Respondent understood Company P's investment objectives as preservation of capital, liquidity, earned income that could be disbursed to Company P's operating account, and yield. Tr. 360. He explained to S.G. and C.S. how ARS worked, including the Dutch auction process. Tr. 349.[17] He also provided C.S. with a written explanation of ARS. The document described ARS and the Dutch auction process, including the risk of auction failure. Tr. 350; RX-84. Respondent had a second meeting with C.S. that evening, in which they discussed investing in ARS in greater detail. Tr. 365, 395-396.

Respondent understood after the October 2, 2006, meeting that CCM could buy securities for Company P's account without contacting the client before each transaction. Tr. 373. CCM's authority was limited to what was in the Proceeds Escrow Agreement. CX-115; Tr. 372-374. CCM invested most of Company P's funds in ARS. Tr. 360.

Respondent provided monthly account statements to its clients, and CCM provided its own separate statement. JX-2.9; CX-164; Tr. 923, 1532. CCM also provided online access to its account to Company P. RX-31; Tr. 134-139. Company P's board of directors received monthly financial reports from its financial people, including a cash position report, as well as a monthly PowerPoint presentation and a detailed spreadsheet. Tr. 1532, 1610-1611.

[17] S.G. testified that Respondent did not explain how the Dutch auction process worked, and claimed that she did not understand the process until March 2008, after the market collapse. CX-122; Tr. 1372. The Extended Hearing Panel did not find this testimony credible, and found that Respondent's testimony that he explained the process to S.G. and C.S. was very credible. In fact, the Extended Hearing Panel found neither witness from Company P to be credible because both were sophisticated business people who professed ignorance and lack of understanding of the company's investments over a sixteen month period. The Panel does not find it credible that two highly qualified and experienced professionals like S.G. and C.S. would have agreed to stake their company's future on something that was completely unfamiliar to them, and failed to learn anything about the investments on which the future of their enterprise depended. Tr. 1604. P.F. described the funds in the CCM account as the "lifeblood" of the company. Tr. 1604. It also would have been consistent with Respondent's interest to explain ARS to his clients so they would be comfortable investing in them.

### B. The ARS Market in Late 2007 to Early 2008, and the February 2008 ARS Market Collapse

In August 2007, there were some failed auctions in ARS collateralized by subprime mortgages and credit card debt (i.e., they were collateralized debt obligations ("CDOs")). Tr. 465. At the time, it was difficult for CCM to get information about what had happened because CCM did not have relationships with Merrill Lynch and Deutschebank, the two underwriting broker-dealers that ran the failed auctions. Tr. 466, 468, 1117, 1133.

In a September 7, 2007, e-mail that Enforcement cites as proof of Respondent's lack of confidence in the ARS market, Respondent wrote to a friend who was very experienced in the ARS market, saying, "The auction market is in trouble. I heard something like $40 billion in resets have failed in the last month. It is making managing cash very difficult." CX-38; Tr. 473-474. Respondent wrote that the market was in trouble because the CDO segment of the market had failed, and the entire ARS market was affected due to misinformation in the marketplace. Tr. 465-466. He learned more in September, in a Merrill Lynch report that had been issued in August, in which Merrill Lynch said there had been failed auctions for $6 billion of ARS backed by CDOs. The report gave Respondent and CCM confidence that the problem was confined to the CDO segment of the ARS market, and was not a systemic problem. Tr. 467, 1122, 2076-2077; CX-40. Respondent and the CCM team felt it was an isolated incident involving securities that were very different from those that CCM bought for its clients, and in a very small segment of the ARS market in which CCM would never invest for its clients. Tr. 218, 467, 1118-1119, 1132. Respondent did not tell CCM clients that $40 billion had failed because he learned that it was inaccurate. Tr. 472-473.

There were other trends in the ARS market that CCM considered to be evidence of a healthy market. There seemed to be more new issues coming out in late 2007, and the underwriting broker-dealers were continuing to sell ARS to their own high net-worth clients. Tr. 943, 944. Respondent and the CCM group believed that the underwriting broker-dealers would not abandon the ARS market, and their own clients, and allow auctions to fail. Tr. 1260-1263. In addition, members of the group spoke to the underwriters with which it dealt, and were told that the underwriters expected to continue to support the auctions. Tr. 2043-2048.

Enforcement also offered evidence intended to show that there were signs in the ARS market that the level of risk was increasing, in support of its contention that Respondent failed to disclose the increased risk to Company P. There was an increase in trailing commissions offered by the issuers in late 2007, in spreads between the interest rates on ARS and the LIBOR, and in the inventories disclosed by underwriting broker-dealers. Tr. 131, 510-511, 628, 652-653, 1124, 1180, 2032. Respondent and CCM did not think this information indicated an increase in risk, but reflected normal market events, including trends that often happened at the end of the year. Tr. 132, 1143.

There was another auction failure in November 2007, but it again involved a CDO. CX-46; Tr. 640. In January 2008, Lehman Brothers and Piper Jaffrey, as underwriting broker-dealers, allowed a few auctions to fail. CCM did not do business with either underwriter. The three CCM members did not believe these failures had any implications for the ARS held by CCM clients. Tr. 1219-1220.

On about February 4, 2008, Merrill Lynch disseminated a marketing brochure that discussed the increasing spreads in the ARS market, describing the greater spreads as an opportunity rather than a cause for alarm. Merrill Lynch represented that it was comfortable with ARS municipals with ratings of at least single-A, and with guaranteed student loan ARS. RX-105 at 2.

The ARS market collapsed in February 2008. CX-166 at 3; Tr. 655-656, 1159. There were more than 1,000 auction failures in a three-day period. RX-111. There had been fewer than 50 in the entire history of the ARS market prior to February 2008, with most, if not all, related to credit problems for the issuers. Tr. 2445; CX-166 at 3. At the time the market failed, there were $330 billion in the ARS market. CX-166 at 3.

Respondent did not call Company P between September 8, 2007, and the market collapse on February 8, 2008. Tr. 2074. Company P lost $12 million due to the auction failures for its ARS.[18] Tr. 1561. The Firm was also injured by the market collapse. The Firm still had an ownership interest of about $7-8 million in Company P in February 2008. Tr. 1532, 1543. In addition, when the market froze, the Firm had more than $9 million in ARS, in the accounts it had set up to permit CCM to provide liquidity to its clients. Tr. 417-418, 2514.

## THE THREE CAUSES OF ACTION ARE DISMISSED

The Extended Hearing Panel dismisses all three causes of action of the Complaint, for the reasons set forth below, although the Hearing Officer does not join in the dismissal of the Third Cause of Action.

## I. The Duty to Disclose Material Information

NASD Rule 2110 required the observance of "high standards of commercial honor and just and equitable principles of trade." Similarly, MSRB Rule G-17 provides, "In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

[18] When the market froze, Company P's account had about $38 million in ARS. The company worked with the Firm to liquidate the ARS, which resulted in the $12 million loss. Tr. 1561-1562.

To establish a violation of Rule 2110 in the absence of a charge of violation of another rule, Enforcement must prove that Respondent acted in bad faith or unethically.[19] Negligent misrepresentations violate FINRA's Rules,[20] as well as MSRB Rule G-17.[21] A registered representative owes a duty to his clients to disclose material information fully and completely, including material adverse facts, when recommending a transaction.[22]

Whether information is material "depends on the significance the reasonable investor would place on the ... information."[23] "A fact is material if there is a substantial likelihood that a reasonable investor would have considered the misstated or omitted fact important in making an investment decision, and if disclosure of the misstated or omitted fact would have significantly altered the total mix of information available to the investor."[24]

## II. Respondent Did Not Fail to Disclose Material Facts Concerning the Purchase of New Issue Securities and Cross Trades

The Extended Hearing Panel dismisses the First Cause of Action, charging that Respondent violated NASD Rule 2110 and MSRB Rule G-17, by failing to disclose material information to CCM's eight limited discretion clients.

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[19] *Dep't of Market Reg. v. Leighton*, No. CLG050021, 2010 FINRA Discip. LEXIS 3, at *157-158 (N.A.C. Mar. 3, 2010)(citing *Chris Dinh Hartley*, Exchange Act Rel. No. 50031, 2004 SEC LEXIS 1507, at *10 n.13 (July 16, 2004)); *Dante J. Difrancesco*, Exchange Act Rel. No. 66113, 2012 SEC LEXIS 54, at *17 (Jan. 6, 2012).

[20] *Dep't of Enforcement v. Pellegrino*, 2008 FINRA Discip. LEXIS 10, at *15 n.13 (N.A.C. Jan. 4, 2008), *aff'd*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843 (Dec. 19, 2008). The Complaint does not charge Respondent with fraud, and contains no allegation of scienter.

[21] *Department of Market Reg. v. Field*, No. CMS040202, 2008 FINRA Discip. LEXIS 63, at *28-29 (N.A.C. Sept. 23, 2008) ("MSRB Rule G-17 requires that, prior to a sale, a dealer or associated person must disclose all material facts concerning the municipal security, and prohibits the omission of any material facts which would render other statements misleading."); *Dep't of Enforcement v. Sisung Sec. Corp.*, No. C05030036, 2006 NASD Discip. LEXIS 16, at *53 n.40 (N.A.C. Aug. 28, 2006), *aff'd in part*, Exchange Act Rel. No. 56741, 2007 SEC LEXIS 2562 (Nov. 5, 2007) (to establish a violation of MSRB Rule G-17 requires a showing of at least negligence).

[22] *Dep't of Enforcement v. Frankfort*, No. C02040032, 2007 NASD Discip. LEXIS 16, at *20 (N.A.C. May 24, 2007); *Dep't of Enforcement v. Kesner*, 2010 FINRA Discip. LEXIS 2, at *19 (N.A.C. Feb. 26, 2010).

[23] *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988).

[24] *Eric J. Brown*, Exchange Act Rel. No. 66469, 2012 SEC LEXIS 636, at *24 (Feb. 27, 2012), citing *Basic, Inc. v. Levinson*, 485 U.S. at 231-32 (1988), and *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

### A. Respondent Did Not Have a Duty to Correct the Alleged Omissions with Respect to AR's Clients

"Liability for failing to disclose material information is 'premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.'"[25] In this case, Respondent had direct responsibility for only three of the eight limited discretion clients. The other five were AR's clients.

Enforcement argues that Respondent had a duty to disclose material facts to AR's clients because CCM acted as a team. Enforcement cites several facts in support of its contention. The names of all three representatives were listed on reports sent to clients, and all members of the group told clients that CCM took a team approach. The three members of CCM shared a representative code for attribution of commissions within the Firm, and Respondent received the highest percentage of CCM's revenues. They discussed whether to offer new issue ARS to the eight limited discretion clients. Respondent was aware that cross trades were being executed, had access to information about the alleged availability of comparable or similar ARS with higher yields than the new issue and cross traded ARS, and was the senior person overseeing the business side of CCM.[26]

On the facts of this case, the Extended Hearing Panel finds that Respondent did not have a duty to make disclosures to AR's clients. While AR's clients may have known that the resources of the group were available as needed, there was not a relationship of trust and confidence between Respondent and AR's clients. Respondent did not work on investment strategies for AR's clients, did not select individual securities for those clients, and did not execute trades for them. There is no evidence that he ever discussed ARS or investment

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[25] *Dep't of Enforcement v. Frankfort*, No. C02040032, 2007 NASD Discip. LEXIS 16, at *21 (N.A.C. May 24, 2007) (citing *Chiarella v. United States*, 445 U.S. 222, 230 (1980)).

[26] Department of Enforcement's Post-Hearing Brief at 4-5, and Department of Enforcement's Reply Brief at 11.

strategies with AR's clients, or even had any contact with AR's clients. In addition, Respondent did not supervise either AR or RD.

### B. The Charge of Failure to Disclose the Purchase of New Issue ARS Is Dismissed

The Complaint charges that Respondent "failed to disclose or cause to be disclosed to the [limited discretion clients] that he (and the Firm) were obtaining additional compensation" on new issue purchases. Complaint ¶ 32.

The Extended Hearing Panel dismisses this charge because Respondent disclosed to his clients that CCM would buy new issue ARS and that CCM received additional compensation for the purchase of new issue ARS.

In addition, under the facts of this case, the Extended Hearing Panel finds that the purchase of new issue securities, and the receipt of additional compensation as a discount, were not material information, and that Respondent did not have a duty to disclose the discounts received by the Firm on the purchase of new issues of ARS. In reaching this conclusion, the Extended Hearing Panel considered the following factors:

- Respondent and CCM disclosed to their clients that the Firm would be compensated by the issuers for all purchases in the customers' accounts. There was no reason for clients to think compensation to CCM would be the same for all investments, and even rates for trailing commissions varied substantially. There is no evidence that Respondent led clients to believe that trailing commissions were the only compensation CCM would receive.
- The interest rate on new issues would reset at auction within about 7 to 35 days. Clients would either receive the new interest rate at the next auction, or the securities would be sold at auction. Thus, even if Enforcement had shown that the

new issues had a lower yield than comparable ARS already on the market, that difference would be rapidly eliminated at the next auction, at little cost to clients.

- CCM's customers were sophisticated, and were well informed of the activity in their accounts. The Firm and CCM sent confirmations for all transactions, and two monthly account statements.
- The discounts that CCM received on new issue purchases were paid by the underwriting broker-dealers out of the discounts the underwriting broker-dealers received from the issuers. Clients did not pay any part of the additional compensation that CCM received.
- The clients provided guidelines to CCM that defined the scope of CCM's authority to purchase securities. There is no evidence that new issue securities did not fit within clients' guidelines, or that CCM applied different selection criteria to new issue securities.
- The industry practice is to make new issue purchases for cash management accounts without disclosing any additional compensation.
- RD purchased new issue ARS for CCM's clients when he believed it was advantageous for clients, primarily to balance their portfolios.

Under these circumstances, the purchase of new issue ARS for the limited discretion accounts was not material information that Respondent was required to disclose to his clients. The Extended Hearing Panel dismisses the charge that Respondent violated NASD Rule 2110 and MSRB Rule G-17 by failing to disclose new issue compensation to limited discretion clients.

### C. The Charge of Failure to Disclose Cross Trades Is Dismissed

The Complaint charges that Respondent "failed to disclose or caused to be disclosed to the [limited discretion clients] that the CCM group was acting as agent for both the buying and selling clients and that, accordingly, it had a conflict of interest when it exercised discretion to select which ARS to purchase." Complaint ¶ 38.

To the extent the practice of making cross trades was material, it was a benefit to clients because it provided liquidity. Because there was essentially no secondary market for ARS, there was no other means of providing liquidity between auctions, except when CCM bought the securities from clients' accounts. In fact, cross trading was touted by some brokers as a service to clients. Clients also benefitted because cross trading could be used to rebalance their portfolios, providing the diversification for each client.

Enforcement contends that cross trading causes an inherent conflict of interest because the selling client would prefer to sell ARS with the lowest yield, while the buying client would prefer to receive the ARS with the highest yield. This argument ignores the realities of the ARS market and the portfolios. CCM had to follow clients' investment guidelines, so the transfers could not be accomplished if the ARS were inferior in credit quality. To the extent that there might be a small difference in interest earned until the next auction as a result of an increase in market interest rates since the previous auction, the benefits of liquidity were much more important to clients than a small difference in interest income.

The Extended Hearing Panel dismisses that charge that Respondent violated NASD Rule 2110 and MSRB Rule G-17 by failing to disclose cross trading in limited discretion clients' accounts.

### D. The Charges of Failure to Disclose the Availability of Comparable or Similar ARS that Paid a Higher Rate of Interest Are Dismissed

For the new issue ARS purchases, the Complaint charges that Respondent violated NASD Rule 2110 and MSRB Rule G-17 because he "failed to disclose or cause to be disclosed to the [limited discretion clients] … that comparable or similar ARS were available that paid a higher rate of interest." Complaint ¶ 32. Similarly, for the ARS cross trades, the Complaint charges that Respondent "failed to disclose to the buyers that for each of these 32 [cross] trades, comparable or similar ARS were available that paid a higher rate of interest." Complaint ¶ 38.

Both parties presented expert testimony on the availability of "comparable or similar" ARS with higher yields than those purchased as new issues. JD testified for Enforcement that he found that there was a widespread and systematic buying of lower yielding securities when comparable or similar higher yielding securities were available.[27] Tr. 1653; CX-166. He examined ARS available from the inventories of the underwriting broker-dealers, as listed on the inventory sheets that CCM sent to its self-directed clients, and found that there were 53 comparable ARS available from the inventory sheets that had higher yields than the new issue and cross traded ARS that were bought for client accounts, and eight for which there were similar ARS with higher yields. Tr. 1653. Respondent presented an opposing expert, ["TB"], who testified that he found no comparable securities offering higher yields for any of the 64.[28] Tr. 2224; see also RX-149 at 4.

[27] JD defined "comparable" as ARS for which "the issuer type (i.e. Revenue, GO, Municipal) and primary characteristics (i.e. Insured Credit Rating, Reset Frequency, Tax Status, Existence of Insurance, and Refinancing Risk) are essentially the same between the actual ARS traded and the alternate ARS identified with a higher yield." He defined "similar" as ARS for which "the issuer type is the same, but some of the primary characteristics are somewhat different (i.e. the reset periods are different, or the traded ARS was tax-exempt and not subject to AMD, but the alternate ARS was subject to AMT) between the actual ARS traded and the alternate ARS with the higher yield." CX-166 at 12.

[28] TB is well qualified to testify and was quite credible. He is a consultant specializing in securities and financial economics, "concentrating on structured finance products, financial engineering, and risk management." Before his consulting career, he was a trader for Bank P's Structured Products and Credit Derivatives Team. RX-14a.

JD's analysis was based on his determination that ARS were comparable if certain characteristics were "essentially the same," and "similar" if there were primary characteristics that were "somewhat different." He found comparability or similarity despite variations in credit rating (Tr. 1680), reset frequency (Tr. 1680), auction date (Tr. 1680), the underlying source of revenue (e.g., an airport bond could be comparable to a health facility bond) (Tr. 1689-1690, 1718-1719; CX-166 at 134), certain loan terms (Tr. 1694; CX-166 at 122), and maximum rate (Tr. 1710; CX-166 at 122).

TB looked at a larger set of factors that he deemed relevant in making comparisons. Although he recognized that some factors were more important than others, he identified at least the following factors as being relevant to comparing and selecting ARS: the issuing state, insurance, collateral, frequency of reset, auction date or cycle, credit rating, whether the issue was public or under SEC Rule 144A, size of the issue, final maturity, taxability, availability of credit insurance, the identity of any credit insurer, identity of the lead underwriter, and the auction dealer. Tr. 2215-2221, 2312, 2330, 2334; RX-149 at 22.

Enforcement has not established that there were comparable or similar ARS available that had a higher yield, requiring disclosure to CCM's limited discretion clients. Enforcement's analysis assumes that there cannot be factors other than those considered by JD that justify selecting a lower-yielding ARS. Many other factors, including those identified by TB and those used by RD, are clearly relevant. Furthermore, the higher yield of the securities identified by JD suggests that the market might have determined that they bore higher risk than the new issues, for reasons not included among the factors used in JD's comparability analysis.[29] In addition, JD glossed over the differences between the ARS selected for clients and the "comparable or similar" ARS, finding that the differences even in his own criteria were not important enough to justify different yields. The market, and reasonable brokers, may well have had a different view.

Another factor considered by the Extended Hearing Panel is that the difference between the interest that would be earned on the securities bought and those that were allegedly comparable was often not substantial. For new issues, the interest rates would change within 7 to 35 days of issue; for securities that were traded among clients' accounts, the interest rate would reset sooner. In some of the transactions, the difference in income between the securities selected by JD and those selected by RD would be so small that clients would likely not want to be bothered by a call from CCM, and insufficient to outweigh the exercise of judgment by CCM. *See*, e.g., Tr. 1935-1936, 1942 ($10 difference until next reset).

The Extended Hearing Panel finds that Enforcement has not shown that there were comparable or similar ARS with higher yields than the new issue and cross traded ARS selected by CCM. Respondent did not violate NASD Rule 2110 or MSRB Rule G-17 by failure to disclose the availability of such ARS.

## III. Second Cause of Action: Respondent Did Violate NASD Rule 2110 and MSRB Rule G-17 by Failing to Disclose to Company P that the ARS Market Was "Under Stress or Otherwise in Trouble"

The Second Cause of Action charges Respondent with failing to disclose to Company P in the six months preceding the collapse of the ARS market that the market was "under stress or otherwise in trouble." Complaint ¶ 67. Enforcement alleges that Respondent "understood" that

[29] In support of his opinion that Respondent had a duty to warn Company P that risk in the ARS marketplace was increasing in the fall of 2007, JD testified that increasing spreads in the ARS market indicated a "huge increase in risk." Tr. 1662-1663. If increasing spreads indicate a huge increase in risk for the overall market, they also must represent a greater risk in comparing individual ARS. He did not consider spreads in identifying the allegedly comparable ARS with higher yields. CX-166 at 12, 115-188.

the ARS market was "in trouble" by September 2007, and failed to inform Company P of his concerns until the market collapse in February 2008.

Respondent did not think there was an increase in risk in the marketplace for the types of ARS that CCM bought for its clients prior to the collapse of the market. He investigated the situation, evaluated the information he received, and reasonably believed that the increase in risk affected only segments of the ARS market in which CCM did not participate on behalf of its clients, primarily the CDO segment.

Respondent also did not negligently fail to recognize signs of market failure and disclose the risk of the ARS market to Company P.[30] The vast majority of auctions were proceeding successfully, new issues were coming on the market regularly, the market was large, underwriting broker-dealers were putting their high net-worth clients in ARS, the dollar amount and number of auction failures were small relative to the size of the market, the auction failures involved underwriting broker-dealers that CCM did not use, CCM invested only in highly-rated ARS, and there had been few auction failures in the 25 years of the existence of the ARS market. Respondent was not negligent in failing to see that auction failures, and especially a market collapse, had become a risk to Company P that required disclosure.

The Extended Hearing Panel dismisses the Second Cause of Action.

## IV. Third Cause of Action: Respondent Did Not Exercise Discretion Without Written Authority – NASD Rules 2510 and 2110

NASD Conduct Rule 2510(b) provides:

> No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the

[30] It is unclear whether Enforcement contends that Respondent was negligent in failing to see the risk and disclosing it to Company P. Read broadly, the Complaint appears to charge that there were signs of risk, and he was negligent in failing to disclose the allegedly increasing risk in the ARS market to Company P regardless of his beliefs about the health of the market.

> member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Rule 3010.[31]

The majority of the Extended Hearing Panel concludes that NASD Rule 2510 does not require written authorization for the exercise of discretion under the facts and circumstances of this case. The practice in corporate cash management accounts is to exercise limited discretion without written authorization, because such accounts are not considered discretionary. *See*, Tr. 2392-2395, 2412. The accounts were managed according to investment guidelines established or approved by clients. Respondent's supervisor and compliance officer approved.

The majority of the Extended Hearing Panel dismisses the charge that Respondent violated NASD Rules 2510(b) and 2110 by exercising discretion in clients' accounts without written authorization.[32]

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[31] A violation of NASD Rule 2510 is also a violation of Rule 2110. *Dep't of Enforcement v. Merhi*, No. E072004044201, 2007 NASD Discip. LEXIS 9, at *33 n.20 (N.A.C. Feb. 16, 2007); *see also, Kirlin Sec.*, Exchange Act Rel. No. 61135, 2009 SEC LEXIS 4168, at *59-60, n.81 (Dec. 10, 2009).

[32] The Hearing Officer disagrees with this finding, and would find that Respondent violated NASD Rules 2510 and 2110. The plain language of NASD Rule 2510 requires written authorization and approval for the exercise of "any discretion," other than narrow exceptions that do not apply. In light of the factors cited by the majority in support of the dismissal, the Hearing Officer would issue a Cautionary Action Letter to Respondent.

## Conclusion

The Extended Hearing Panel dismisses the Complaint.[33]

**EXTENDED HEARING PANEL**

______________________________
Lawrence B. Bernard
Hearing Officer

Copies to: Respondent (via overnight courier and first-class mail)
Jason Mogel, Esq. (via electronic and first-class mail)
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Daniel A. Cantu, Esq. (via electronic mail)
David R. Sonnenberg, Esq. (via electronic mail)

[33] The Extended Hearing Panel has considered all the arguments advanced by the parties, and rejects or sustains them to the extent that they are inconsistent or in accord with the views expressed herein.