BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

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| In the Matter of<br><br>District Business Conduct Committee<br>For District No. 7,<br><br>Complainant,<br><br>vs.<br><br>Wayne B. Vaughan<br>Atlanta, Georgia,<br><br>Respondent. | DECISION<br><br>Complaint No. C07960105<br><br>District No. 7 (ATL)<br><br>Dated: October 22, 1998 |

Respondent Wayne B. Vaughan ("Vaughan") appealed the January 28, 1998 decision of the District Business Conduct Committee for District No. 7 ("DBCC") pursuant to Procedural Rule 9310. We also called this matter for review pursuant to Procedural Rule 9312 to determine whether the sanctions imposed by the DBCC were appropriate in light of the violations. After a review of the entire record in this matter, we affirm the DBCC's finding that Vaughan engaged in unsuitable trading for his customer's account in violation of Conduct Rules 2110 and 2310. We affirm the DBCC's imposition of a censure and increase the suspension from 20 to 30 business days in all capacities. We also order Vaughan to requalify by examination, following his suspension, in any capacity in which he seeks to participate in the securities industry.

Background

Vaughan first entered the securities industry in 1962, and he became registered with the NASD as a general securities sales representative in July 1970. He was associated with various broker/dealers over the next 14 years. He joined PaineWebber, Inc. ("PaineWebber") in March 1984, Prudential Securities ("Prudential") in April 1989, Oppenheimer & Company ("Oppenheimer") in April 1992, and Raymond James & Associates ("Raymond James") in August 1993. In December 1996, he joined Attkisson, Carter & Akers, Inc., where he currently is employed and registered as a general securities sales representative. He testified that approximately 10 percent of his work today involves managing individual accounts, and the rest of his work involves financial planning. Vaughan has no prior disciplinary history.

VB, the customer, filed an arbitration claim against Raymond James, Oppenheimer, and Vaughan, which was settled in December 1996 for $72,000.[1] Vaughan did not contribute to the settlement.[2]

Facts

In 1982, VB received an $85,000 cash settlement from her husband, from whom she had separated that year. This settlement comprised proceeds from the sale of their home and represented substantially all of VB's assets. After her separation, she received Social Security payments and $1,000 per month in alimony, and she bussed tables and worked as a hostess at her brother's barbecue restaurant on an "as needed" basis to supplement her income. According to her federal tax returns, her adjusted gross income for the years 1991 through 1993 was $35,992, $26,216, and $9,311, respectively.

VB does not own a home, and she claimed that before her separation, she had no investment experience. Before she was married, she worked for about six years as a secretary and for about two years at the University of Georgia as a bookkeeper. Villeneuve testified that she believed that VB's duties as a bookkeeper were purely clerical.

VB invested the $85,000 with a broker from Merrill Lynch, Pierce, Fenner & Smith, Inc. named James Weigel ("Weigel"), whom she had met at her brother's restaurant in Atlanta. Weigel subsequently moved to PaineWebber and took VB's account with him. VB stated that Weigel had recommended mutual funds to her, but the record evidence shows that she traded index options and junk bonds in her account with Weigel.

Vaughan's Management of VB's Account at PaineWebber. Vaughan took over VB's account at PaineWebber after Weigel retired in August 1988. At that time, VB had approximately $50,000 in a margin account, which she had used to participate in an options trading program. Vaughan testified that VB had lost a lot of money and that she wanted to rebuild her account. He claimed that he told VB that options were too risky for her and that buying small-cap stocks on margin was as aggressive as he would advise her to be. Vaughan initially purchased the following securities for her account: $80,000 (face value) worth of zero-coupon Treasury bonds at $42.10, maturing on February 15, 1999, and $5,100 worth of a bond fund called Blackrock Term Trust ("Blackrock") at $10 per share, maturing in December 1999.

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1 VB refused to attend the DBCC hearing, and she offered her version of events through a sworn declaration and through an interview with Jane Villeneuve ("Villeneuve"), an NASD examiner for District No. 7, who testified at the DBCC hearing.

2 Vaughan testified that he was going through bankruptcy proceedings at the time and therefore was not able to contribute to the settlement.

Vaughan's Management of VB's Account at Prudential. Vaughan left PaineWebber for Prudential in April 1989. According to Vaughan, VB asked Vaughan to purchase securities that would increase in value faster than the bonds he had purchased for her account. In June 1989, Vaughan sold VB's Treasury bonds for a $1,900 profit and purchased RJR Nabisco Holdings Corp. ("RJR") bonds. Vaughan sold the Blackrock shares in October 1990 for a $1,800 loss. In 1991, Vaughan sold the RJR bonds for a profit of more than $8,200. VB's account value reached more than $120,000 while at Prudential.

Vaughan's Management of VB's Account at Oppenheimer. Vaughan brought VB's account with him when he joined Oppenheimer in May 1992. VB, who was at that time 69 years old, had approximately $95,000 in her account at the time of the transfer. Both the Oppenheimer new account form, which was completed in April 1992, and the amended new account form, which was completed in November 1992, indicated that VB had a net worth of $300,000. VB did not sign either of these forms, however, and there is no evidence that VB had any assets other than the $95,000 in her securities account. Vaughan testified that he did not know who recorded the "$300K" net worth entries on the new account forms.

The new account form also listed VB's sole trading objective as "long term growth." The amended account form indicated five investment objectives, which were not prioritized: fixed income, income moderate growth, long-term growth, short-term trading and business-risk appreciation. William Lobb ("Lobb"), Oppenheimer's Atlanta branch manager, sent VB a letter which indicated that the firm believed her net worth to be $300,000 and that her trading objectives included short-term trading, among others. The letter requested her to contact the firm if its assumptions were incorrect. VB did not respond to the letter.

It is undisputed that while at Oppenheimer, Vaughan put VB on margin and increased the trading in her account, and the account lost money. Between May 1992 and August 1993, Vaughan made 60 purchases and 60 sales, primarily of over-the-counter ("OTC") stocks. The annualized turnover ratio in VB's account was 7.1. The account sustained trading losses of $51,115 and carried a large margin debit. Of the positions established, none were held more than eight months, 96 percent were held six months or less, 69 percent were held three months or less and 30 percent were held less than one month. VB paid $35,686 in commissions, $14,142 of which went to Vaughan, and $3,365 in margin interest. VB made three withdrawals totaling $21,000.

In December 1992, Paul Vogel ("Vogel"), who was the operations and compliance manager in Oppenheimer's Atlanta office, received a Compliance Review Report that cited VB's account for excessive trading activity and commissions. Vogel was concerned, and he reviewed VB's account with Vaughan. Vogel did not remember what he had said or what Vaughan's response was.

Lobb and Vogel met with Vaughan on February 19, 1993, after a second Compliance Review Report listed VB's account. Following the meeting, Lobb and Vogel told Vaughan: (1) to get VB off of margin; and (2) to purchase more blue chip and fewer speculative OTC stocks.

Vogel began monitoring VB's account on a daily basis after the meeting. Vaughan testified that he spoke with VB after Vogel told him to take her off of margin, but that VB did not want to liquidate and incur losses.

On March 10, 1993, Lobb received a third Compliance Review Report, which again listed VB's account for review for February account activity. The report showed the following: account equity of $46,794; margin debit of $77,419; month-to-date and year-to-date gross commissions of $5,591 and $9,381, respectively; the number of month-to-date and year-to-date transactions was 23 and 35, respectively; and Vaughan's year-to-date gross commissions for all accounts were $72,388, of which VB's commissions represented 13 percent.

Lobb said that he became concerned when he realized that Vaughan was not following his instructions. Beginning May 13, 1993, Lobb ordered Vaughan to have all of his orders for VB's account approved by either Lobb or Vogel prior to entry. Vaughan resigned from Oppenheimer in June 1993. In his resignation letter, he explained that the restrictions Lobb and Vogel had placed on his trading in VB's account prevented him from working comfortably at Oppenheimer.

<u>Vaughan's Management of VB's Account at Raymond James.</u> Vaughan joined Raymond James in August 1993 and brought VB's account with him. VB had declined Lobb's request that she keep her account at Oppenheimer with another broker. At that time, VB's account had total assets of $71,825, with a margin loan balance of $30,057. The net equity balance was $41,768. VB's new account form at Raymond James listed her primary investment objectives as long-term growth and short-term trading, and her secondary trading objectives as income and speculation. At the time of transfer, six of eight stocks in the account were carried on margin.

Frank Hudson ("Hudson"), the branch manager at Raymond James, examined VB's account and expressed concern about the use of margin and the frequent purchase and sale of OTC stocks. Hudson and Vaughan agreed that the margin balance would be eliminated within six months, and Hudson instructed Vaughan to recommend only large-cap, blue chip stocks to VB. Although Vaughan initially complied, he soon sold the blue chip stocks and began purchasing speculative OTC stocks again. He told Hudson that VB was dissatisfied with the performance of the blue chip stocks. Vaughan did not comply with Hudson's instructions to eliminate the margin balance within six months.

The following activity occurred in VB's account while at Raymond James: Vaughan effected 57 transactions (26 purchases totaling $198,984 and 31 sales totaling $239,709); VB's account sustained losses of $36,629; VB paid $7,124 in commissions, of which Vaughan received $2,974; of the positions established, none were held more than one year, five were held more than six months, 22 were held less than six months, 15 were held less than three months and six were held less than one month. The turnover ratio in VB's account at Raymond James was 5.7. VB withdrew a total of $2,150 from her account.

According to VB's sworn affidavit, she first became aware of the situation in her account in September 1994 when she asked her ex-husband for more alimony. Her ex-husband's attorney requested her financial records and inquired about the "$450,000" account she had at Raymond James. VB asked Vaughan, who explained that the "$450,000" notation reflected accumulated purchases made and not the account balance. When her ex-husband's attorney realized the actual balance in the account, he suggested that she have a financial professional look into the matter. She wrote a letter to Hudson at Raymond James and told him that she wanted to pay off her margin balance and stop trading in her account. After her account was closed, she was left with $8,200.22. On September 8, 1994, she sent a letter of complaint to the Atlanta District Office of the NASD.

Discussion

Vaughan argued before the DBCC and in his brief on appeal that his recommendations were not unsuitable because VB was a "sophisticated investor" who wanted to engage in risky trading. At the hearing before a subcommittee of the National Adjudicatory Council (the "NAC") on July 21, 1998 (the "NAC Hearing"), however, Vaughan showed a willingness to accept the DBCC's finding of unsuitability. He admitted that he had exercised poor judgment with respect to his management of VB's account and that the situation had gotten "out of control" for him. In a letter he wrote to the NASD Regulation Office of General Counsel several weeks before the NAC Hearing, he admitted that he "realized too late that this trading was not in [VB's] best interest." He nonetheless continued to assert at the NAC Hearing that VB was a "sophisticated investor" and that he did not "feel like [he] created the situation."

We emphasize at the outset that Vaughan did indeed "create" the "situation," and he alone is responsible for what we find to have been an unsuitable course of trading for VB's account. After a thorough review of the record, we affirm the DBCC's finding of unsuitability. Our finding of a suitability violation is predicated on the speculative nature of the securities Vaughan recommended to VB, the fact that Vaughan recommended the use of a margin account, and the excessive number of purchases and sales Vaughan recommended in VB's account.

Vaughan Recommended Speculative Securities. A broker must make a customer-specific determination of suitability, and he or she must recommend only those securities that fit the customer's financial profile and investment objectives. In re F.J. Kaufman and Co. of Virginia, 50 S.E.C. 164, 168 (1989). The broker must make recommendations based on the information he or she has about the customer, rather than on speculation. In re Eugene J. Erdos, 47 S.E.C. 985, 988 (1983). Vaughan knew that VB was in her late 60's when he took over her account. He knew that she had a limited income, which consisted primarily of alimony payments and Social Security payments. Vaughan even testified that when he took over VB's account at PaineWebber, he recommended that she stop trading options, as these were too risky for someone with her financial profile. He thus initially recognized that there were certain constraints on the kind of trading he should recommend to VB, given her financial situation. Indeed, the undisputed evidence shows that other than her limited, fixed income, the money she had invested with Vaughan comprised substantially all of her assets. She therefore needed conservative investments, given her age and limited income. Vaughan, however, recommended low-priced, speculative securities.

"A salesman's duties respecting suitability are heightened in the context of such low-priced stock transactions." In re Douglas Jerome Hellie, 50 S.E.C. 611, 613 n.8 (1991). We find that the speculative securities that Vaughan recommended for VB's account, such as Calgene, Inc., Liposome, Inc., and Pittencrief Communications, Inc., were inappropriate at the time given VB's financial needs and situation. These stocks carried a degree of risk that VB was not able to bear. Furthermore, they comprised an inappropriate percentage of VB's holdings, which compounded the risk posed by the volatile nature of the stocks.

At the NAC Hearing, Vaughan and his counsel tried to paint VB as a "sophisticated investor" who enjoyed trading in speculative securities. Vaughan asserted that VB had previously engaged in a risky trading strategy when she traded with Weigel, who had put her in index options and junk bonds. Vaughan's counsel described VB as someone who had engaged in "sophisticated trading, enjoyed that, and insisted upon it." A customer's prior transactions, however, are not relevant in a suitability determination, and we do not find that VB's history of risky trading mitigates Vaughan's conduct. In re Larry Ira Klein, Exchange Act Rel. No. 37835 (Oct. 17, 1996); see also In re Douglas Jerome Hellie, supra (prior transactions are irrelevant in suitability determination). The fact that VB had traded junk bonds and index options in the past does not mean that she understood the risks involved. She could very well have been following the recommendations of her broker at that time. Furthermore, we find that VB lacked the educational and experiential background to evaluate Vaughan's trading strategy.

Vaughan and VB offered conflicting accounts of the nature and extent of their interaction and communication throughout their broker/customer relationship. On the one hand, VB claimed that while she and Vaughan spoke monthly, he rarely called her before executing a purchase or sale. She asserted that Vaughan never discussed the risks of his recommendations with her, and that he frequently did not get her permission before he traded in her account. She claimed, however, that she had faith in him and that she therefore relied on him. Vaughan, on the other hand, claimed that VB never complained to him about not understanding transactions in her account or about unwanted transactions in her account. He claimed that VB even sometimes called him with trading ideas based on the research reports he sent to her.

We agree with the DBCC that VB most likely did not understand the risks associated with Vaughan's trading strategy and that she would probably not have consented to Vaughan's strategy had she understood the risks. We emphasize, however, that even if VB encouraged Vaughan to trade the speculative stocks he recommended for her account, this would not mitigate Vaughan's violative conduct. The fact that a customer expresses an interest in a higher return on her investments does not make high-risk investments suitable if she does not understand the risk involved. As the Securities and Exchange Commission ("SEC") has recognized, it is not surprising that an unsophisticated investor would express interest in a higher return if he or she was not adequately informed of the link between risk and return. In re Larry Ira Klein, supra. A broker must always be satisfied that the customer understands the risks involved in the trading strategy and is not only able but willing to take those risks. In re Arthur Joseph Lewis, 50 S.E.C. 747, 749 (1991). Therefore, even if VB instructed Vaughan to purchase the speculative securities he recommended for her account, her instructions would be irrelevant to our suitability determination.

In fact, however, there is no evidence that Vaughan educated VB about the risks associated with the securities he recommended while at Oppenheimer and Raymond James. It is undisputed that Vaughan never told VB that she could lose substantially all of her money through his trading strategy. Vaughan asserted that he sent VB information about the stocks he recommended for her account, but we do not find this to be a mitigating factor. The delivery of a prospectus does not absolve a broker of his duty to inform the customer fully of the risks associated with the proposed investment. In re Larry Ira Klein, supra. In any event, we do not find that Vaughan believed that VB understood the risks associated with his trading strategy. He testified at the DBCC hearing that he "was concerned that she didn't know what she was doing" and that he was worried "that she was losing money."

Even if Vaughan had explained the risks to VB, the securities he recommended for her account would still have been unsuitable. The SEC has made clear that even in those situations where a customer seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. See In re John M. Reynolds, 50 S.E.C. 805, 809 (1992) (regardless of whether the customers wanted to engage in aggressive and speculative trading, the representative was obligated to abstain from making recommendations that were inconsistent with their financial situation); In re Gordon Scott Venters, 51 S.E.C. 292, 294-95 (1993) (same).

In sum, VB was an inexperienced investor with limited income. As the undisputed evidence showed, the $95,000 she invested with Vaughan comprised substantially all of her assets. Given her age, limited income and limited assets, her overriding need was preservation of principal through conservative investments. Vaughan's recommendations of risky, speculative securities were therefore wholly unsuitable.

Vaughan Recommended A Margin Account. We also find that the frequent use of a margin account was per se unsuitable for VB. VB's ability to repay her large margin debts was constrained by her limited income and the rapidly declining value of the speculative stocks that she held. For instance, by July 1994, her margin debit was approximately $16,244, while the total assets in her account totaled just $25,312. Her margin debit therefore represented more than 60 percent of the total value of her account. Furthermore, she had sustained losses of approximately $45,000, including $7,124 in commissions, since August 1993.

There is no evidence that Vaughan ever explained to VB the risks associated with purchasing securities on margin. Although Vaughan claimed that he and VB discussed going on margin, he did not make clear whether he explained the risks to her or whether he merely suggested she open a margin account. VB claimed that Vaughan recommended a margin account, which she agreed to without understanding the risk involved. She claimed that she always signed the forms that Vaughan gave her every time they moved to a new brokerage firm, but that she never understood what she was signing.

It seems unlikely that Vaughan explained the risks to VB and that VB understood them. Vaughan testified at the DBCC hearing that the fact that VB was operating on margin "scared him to death."[3] And yet when Vaughan's supervisors at Oppenheimer and Raymond James ordered him to take VB off of margin and to purchase blue chip stocks for her account instead of the speculative OTC stocks he had been purchasing, he nonetheless kept her on margin and continued to purchase highly speculative stocks. It should have been obvious to Vaughan that a customer with VB's financial profile has an overriding need for safety of principal and that the frequent trading in her margin account would only jeopardize her principal.[4] We find that the recommendation of a margin account was incompatible with VB's financial profile and was therefore unsuitable.

Vaughan Recommended the Frequent Purchases and Sales of Stocks. Finally, Vaughan recommended a course of excessive trading of speculative stocks that was unsuitable for VB.[5] VB's accounts had excessive turnover rates. Based on the modified Looper formula, the annual turnover rate in VB's account was 7.1 while at Oppenheimer and 5.7 while at Raymond James.[6] It is clear that VB was financially unable to bear the risks associated with the frequent purchases and sales of large amounts of speculative stocks, and that Vaughan therefore had a duty to

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[3] This testimony is inconsistent with his assertions that she was a savvy investor, who understood the risks associated with the trading activity in her account.

[4] "The effect of trading on margin is to leverage any position so that the systematic and unsystematic risks are both greater per dollar of investment." In re F.J. Kaufman & Co. of Virginia, 50 S.E.C. at 165 n.1 (quoting T. Copeland & J. Weston, Financial Theory and Corporate Policy 306 (3d ed. 1988)).

[5] The NASD Board of Governors' policy statement with respect to fair dealing with customers, which appears in the NASD Manual following the suitability rule, provides in pertinent part as follows: "Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are . . . [e]xcessive activity in a customer's account . . . ." IM-2310-2.

[6] The turnover ratio is calculated by applying the "Looper formula," named after In re Looper & Co., 38 S.E.C. 294 (1958), which divides the total cost of purchases made during a given period by the average monthly investment. See In re Frederick C. Heller, 50 S.E.C. 275, 276-77 (1993). The turnover ratio is computed "by dividing the aggregate amount of the purchases by the average cumulative monthly investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." Id. at 279 n.10. A modified Looper formula divides the total cost of purchases by the average monthly equity. See In re Allen George Dartt, 48 S.E.C. 693 (1987); Report of the Special Study of the Options Markets to the Securities and Exchange Commission, H.R. Com. Print IFC3, 96th Cong., 1st Sess. (1978).

recommend a course of trading that offered a degree of risk commensurate with her overriding need for retention of principal. This he failed to do. Instead, through a combination of excessive commissions and trading losses, VB suffered a total loss of about $86,000. As a result of his improper recommendations, Vaughan was able to earn a higher rate of commissions at VB's expense. All of the evidence makes clear that Vaughan failed to discharge his fundamental duty to recommend a course of trading suitable to his customer in violation of NASD Conduct Rules 2110 and 2310.

Sanctions

We note that the 1996 edition of the NASD Sanction Guidelines ("Guidelines") for suitability recommends a suspension in all capacities for 10 to 30 business days for cases involving numerous unsuitable recommendations and no prior similar misconduct. We affirm the DBCC's decision to impose a censure, but we increase the suspension from 20 to 30 business days, the upper range recommended by the Guidelines, and thereafter until he requalifies by examination in any capacity in which he seeks to participate in the securities industry.[7] We find that this conclusion is supported by the factors to be considered in determining the appropriate sanction for a suitability violation.

We note that Vaughan has no prior disciplinary history and that VB's account appears to have been the only account he managed in which this kind of trading activity occurred. Nonetheless, we find that his conduct was egregious. Of all the accounts he managed, VB's account generated the highest level of commissions for him. While Vaughan was at Oppenheimer, the commissions he generated from trading in VB's account represented 13 percent of his overall commissions from all accounts. We are also troubled by the fact that Vaughan did not contribute to the arbitration settlement, and the fact that during the six years that Vaughan controlled VB's account, the customer lost about 90 percent of her original assets plus opportunity costs. Although Vaughan is currently involved primarily in financial planning, he still spends approximately 10 percent of his time managing individual accounts. We therefore believe that giving Vaughan the maximum sanction recommended by the Guidelines best serves the public interest. We have also determined that requiring Vaughan to requalify by examination will impress upon him the seriousness of his violation and remind him of his responsibilities as a member of the securities industry.

Accordingly, Vaughan is censured and suspended from association with any member firm in any capacity for 30 business days and thereafter until he requalifies by examination in any

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[7] The recommended sanctions are consistent with the applicable Guideline. See Guidelines (1996 ed.) at 52 (Suitability Violation). Vaughan filed for personal bankruptcy in May 1995 and was discharged in October 1995. Accordingly, neither the DBCC nor we have imposed any monetary sanctions against him.

capacity in which he seeks to do business. Pursuant to Rule 9360, the Chief Hearing Officer shall set the date on which the 30-business-day suspension shall begin.[8]

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

[8] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.