BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. William J. Murphy Midlothian, Illinois, Carl M. Birkelbach Chicago, Illinois, and Birkelbach Investment Securities, Inc. Chicago, Illinois, Respondents.	DECISION Complaint No. 2005003610701 Dated: October 20, 2011

Hearing Panel found that: (1) a registered representative engaged in discretionary trading without written authorization from his clients or firm; engaged in excessive and unsuitable options trading; churned customer accounts; engaged in unauthorized trading; and caused the creation and sending of inaccurate, unbalanced, and misleading communications; (2) a registered general securities and options principal failed to supervise; and (3) a member firm included an improper confidentiality provision in a settlement agreement. The Hearing Panel barred the representative and ordered $591,933.67 in disgorgement; fined the general securities and options principal $25,000, suspended him for six months as a general securities principal and an options principal, and required requalification in those principal capacities; and fined the firm $2,500. Held, findings affirmed; sanctions imposed on the general securities representative affirmed in part and modified in part; sanctions imposed on the general securities and options principal increased; sanctions imposed on the firm affirmed.

Appearances

For the Complainant: Leo F. Orenstein, Esq., Marcletta Kerr, Esq., Dale Glanzman, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondents: James J. Moylan, Esq., Kendra Thramann Marderosian, Esq.

Decision

Pursuant to NASD Rule 9311(a), William J. Murphy ("Murphy"), Carl M. Birkelbach ("Birkelbach"), and Birkelbach Investment Securities, Inc. ("BIS" or "the Firm") appeal a May 6, 2010 Hearing Panel decision. The Hearing Panel considered a nine-cause complaint concerning Murphy's handling of two customer accounts, Birkelbach's supervision of Murphy's conduct, and the Firm's inclusion of a restrictive confidentiality clause in a settlement agreement with one of the customers involved. The Hearing Panel found that Murphy: (1) engaged in discretionary trading without written authorization from his clients or the Firm, in violation of NASD Rules 2510(b), 2860(b)(18), and 2110 (cause one)[1]; (2) engaged in excessive and unsuitable trading, in violation of NASD Rules 2310, 2860, and 2110, and IM-2310-2 (cause two); (3) churned customers' accounts, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 thereunder, and NASD Rules 2120, 2310, 2110 and IM-2310-2 (cause three); (4) traded beyond the approved level in a customer's account and engaged in unauthorized trading, in violation of NASD Rule 2110 (cause four); and (5) caused the creation and distribution of inaccurate, unbalanced, and misleading communications, in violation of NASD Rules 2210, 2220, and 2110 (cause five). The Hearing Panel found that Birkelbach failed to supervise Murphy, in violation of NASD Rules 3010, 2860(b), and 2110 (cause seven). The majority of the Hearing Panel also found that BIS used an improper confidentiality provision in a settlement agreement with one of Murphy's customers, in violation of NASD Rule 2110 (cause nine). The Hearing Panel, however, dismissed or did not address certain allegations in cause five; dismissed cause six, which alleged that the Firm maintained deficient written supervisory procedures; and dismissed cause eight, which alleged that the Firm failed to maintain correspondence in its files.

The Hearing Panel barred Murphy in all capacities for his violations, excluding his creating and distributing of misleading communications for which it imposed no separate

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[1] Following the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA, FINRA began developing a new "Consolidated Rulebook" of FINRA Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See FINRA Regulatory Notice 08-57* (Oct. 2008). Because the complaint in this case was filed before December 15, 2008, the procedural rules that apply are those that existed on December 14, 2008. The conduct rules that apply are those that existed at the time of the conduct at issue.

Unless otherwise noted, the versions of the rules that are cited and quoted appear in the 2006 edition of the NASD Manual.

sanction, and ordered that he pay disgorgement totaling $591,933.67. For Birkelbach's engaging in supervisory violations, the Hearing Panel fined him $25,000, suspended him for six months as a general securities principal and an options principal, and required that he re-qualify before serving again in either of those principal capacities. Finally, the Hearing Panel fined BIS $2,500 for using an improper confidentiality provision in a settlement agreement.

After a complete and independent review of the record, we affirm the Hearing Panel's findings.[2] We affirm the bar imposed on Murphy, but we reduce the disgorgement award to $585,174.67, to account for ill-gotten gains that he no longer retains. We increase the sanction on Birkelbach and impose on him a bar in all capacities. We affirm the $2,500 fine imposed on BIS.

I. <u>Respondents' Backgrounds</u>

Both Murphy and Birkelbach are industry veterans. Murphy entered the securities industry in 1985. During his career, he has been registered as a general securities representative and a principal, and he was registered in both capacities with BIS at the time of the alleged misconduct. Murphy has been registered with BIS since November 1995, where he is the second-ranking officer and has held the titles of senior vice president and sales manager. Murphy remains registered with BIS.

Birkelbach registered with BIS in July 1983 as a general securities representative and principal, a municipal securities representative and principal, an options principal, and a financial and operations principal. At the time of the alleged misconduct, Birkelbach was registered in all these capacities with BIS. Birkelbach was president of BIS. From October 2001 through February 2006, he also was the Firm's Senior Registered Options Principal ("SROP") and Compliance Registered Options Principal ("CROP"), which carried the "[u]ltimate responsibility and authority to supervise customer's options transactions." Birkelbach remains registered with BIS.

BIS became a FINRA member on July 22, 1983, and its membership remains active.

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2 The Department of Enforcement ("Enforcement") has not appealed those aspects of the Hearing Panel's decision that either dismissed or did not address allegations. As an exercise of our discretion, we do not review these findings.

II. Factual Background

This proceeding concerns Murphy's handling of the accounts of two of his customers, AL and BM, Birkelbach's supervision of Murphy's activities, and the manner in which the Firm settled an arbitration complaint filed by his customer AL.

A. The AL Account

1. AL Opens an Account at BIS

AL is a mother of three daughters, a writer and illustrator of children's books, and a painter. In 1998, AL received approximately 47,000 shares of Proctor & Gamble ("P&G") stock worth approximately $4 million that her father, a retired P&G executive, had placed in a trust for AL's benefit. AL, as trustee, proceeded to deposit such P&G shares in an account at Fidelity Investments ("Fidelity"). Although she had previously held accounts that held securities, AL had no prior securities trading experience.[3]

In 1999, AL's father died, and AL divorced her husband. In 2001, FD, a trader and AL's trusted friend, recommended that she consider using a "covered call strategy" as a "way to generate income while keeping the principal."[4] On October 2, 2001, FD guided AL through the sale of ten covered call options on P&G stock, through her Fidelity account, to demonstrate how the covered call strategy would work.[5] At the time, AL was aware that LB, whom she was dating and would later marry, held an account at BIS with Pat Jage ("Jage"), a registered

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[3] Prior to opening her Fidelity account, AL owned a joint account at Morgan Stanley with her former husband. AL held securities in her accounts at Morgan Stanley and Fidelity, but she did no trading in those accounts.

[4] The trading at issue in this proceeding involved numerous kinds of options trades, including "covered calls." "An 'option' generally refers to an instrument that provides a right to buy or sell a security at a stated price." *Dep't of Enforcement v. Medeck*, Complaint No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *2 n.1 (FINRA NAC July 30, 2009). A "call option" is a right to buy the underlying stock, whereas a "put option" is the right to sell the underlying stock. *Id.* A "covered call" refers to a strategy in which "an investor writes [i.e., sells] a call option while at the same time owning an equivalent number of shares of the underlying stock." *Id.* (citing sources); *see also* American Stock Exchange et al., *Characteristics and Risks of Standardized Options* at 13 (Feb. 1994) [hereinafter, *Characteristics and Risks*]. An option writer receives a premium for selling an option. *Characteristics and Risks*, at 11. If an option is exercised by the holder (i.e., the purchaser of the option), the option writer must perform according to the terms of the option. *Id.*

[5] It was not until the following month—after AL opened the account at BIS discussed in the next paragraph—that she bought back such call options, which resulted in a short-term loss of $1,205.

representative at BIS. FD recommended to AL that, to effect a covered call strategy, she use BIS and talk to Jage.

On October 5, 2001, AL opened an option and margin account for her trust at BIS with Jage. The BIS account opening documentation included a new account form and an "option agreement and approval form." AL's new account form was approved on October 5, 2001, by BIS' compliance officer, George Langlois ("Langlois"). AL's option agreement was signed on October 8, 2001, by Langlois and Birkelbach. AL deposited into her BIS account 20,000 shares of her P&G stock, which at the time were valued at approximately $1,500,000. AL's understanding was that Jage would pursue only a covered call strategy while preserving her P&G stock.

AL's account opening documents and her testimony provided evidence concerning her financial situation and investment objectives at the time she opened the BIS account. The account documentation identified AL as a 44-year old single mother with three dependents. The documents reflected that AL had been a self-employed artist for 25 years and earned an annual income of "$55,000+." AL testified that a small part of her annual income came from book royalties but that most came from P&G dividends.

With respect to her assets and net worth, the new account form indicated that her "liquid net worth excluding her residence" was "$2,500,000+." In comparison, the option agreement indicated that she had "cash" of "$2,500,000+," "marketable securities" of "$2,500,000+," "real estate (exclusive of family residence)" worth $350,000, and a "total net worth" of "2.5 million+." AL testified that contrary to what the option agreement reflected, she did not have $2.5 million in cash but kept a cash balance in her account of only $20,000 to $30,000.[6]

The account opening documents reflected that AL's investment objectives were "income" and "long-term growth" and "income & appreciation" (with "income" as the top objective) and that her risk exposure level was "moderate." In addition, the option agreement approved AL's account only for "covered writing" and "buying" of stock options. AL testified that her "overall objective" was to "generate income," but that she did not want to sell her P&G shares or let such shares be "called away."[7] The reason was because AL had an emotional attachment to P&G, and her father had advised that there was no need to sell P&G stock because it "was such a

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6 At an on-the-record interview, Murphy testified that his understanding was that AL had a "limited amount" of cash, and he estimated the amount to be "less than six figures" but also "in excess of $100,000."

7 The term "called away" refers to a call option writer's obligation, when such an option is exercised, to sell the underlying security to the holder at the strike price stated in the option. *See, e.g.*, Chicago Board Options Exchange, *Who Should Consider Using Covered Calls?*, at 3 (Dec. 2004), http://www.cboe.com/strategies/pdf/covereccalls.pdf.

diversified company." AL also testified that the tax basis of her P&G stock was low, compared to the current price of the stock, which was another reason to avoid selling it.[8]

Despite the fact that AL had no trading experience, the new account form reflected that she had ten years of investment experience, and the option agreement indicated that she had 25 years of investment experience with stocks and bonds and one year of experience with options. AL testified that Jage had informed her that, to facilitate the opening of the account and to engage in the covered call strategy she sought, inflating her investment experience on the account opening documentation was "a common thing to do." AL's testimony demonstrates that she lacked a sophisticated understanding of options investing in general and the covered call strategy she had requested.

Significantly, the new account form also showed that AL had not granted written discretionary authority over her account to anyone. The parties stipulated that the account was not approved in writing for discretionary trading.

2. Murphy Is Assigned the AL Account

Jage handled AL's account only from October 2001 to June 2002. During that period, Jage effected only covered calls. As of June 17, 2002, Jage's trading had generated $10,650 in trading losses, $17,388 in commissions, and margin interest totaling $891. As of June 28, 2002, the value of AL's account was $1,781,538, and there was no margin debit balance.

In July 2002, Jage became ill and abruptly left BIS. Birkelbach then assigned AL's account to Murphy. At the time, AL was worried and upset about losses she had incurred with Jage, although she believed such losses were greater than they actually were.[9] Murphy "apologized," said that the losses "should never have happened," assured AL that he "would get this money back," and that "this will never happen again, we'll take care of this, we will reduce the commissions, we'll move forward, and we can make money." AL told Murphy to continue using a covered call strategy, and Murphy told AL that he would do so. Just as she told Jage, AL informed Murphy that she did not want her P&G stock to get called away.[10] AL gave Murphy verbal permission, but not written permission, to make trades without contacting her first.

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8 AL testified that her basis in P&G stock averaged $12 to $14 per share. As of November 30, 2001, the price of P&G stock was $77.46 per share.

9 At the time of the transfer, AL believed she "was in debt" in the amount of $41,000. Although her trading losses had grown that high in December 2001, as of June 17, 2002, they stood at only $10,650 and she had no margin debit balance.

10 AL testified that various people, including Murphy and her financial advisor Karen DeRose ("DeRose"), whom Birkelbach introduced to AL around February or March 2004, were encouraging her to diversify her portfolio "all the time," but that she did not want to.

3. Murphy's Trading

After Murphy's assignment to AL's account, the amount of trading and commissions increased dramatically. From July 2002 to February 2006, Murphy effected 2,594 buy and sell options transactions involving more than 67,000 P&G option contracts, activity that generated $1,002,100 in commissions.[11] Murphy effected trades on a substantial number of days—63 days from July 3, 2002 through the end of that year, 135 days in 2003, 183 days in 2004, and 188 days in 2005—and he often made multiple trades a day. Between November 2004 and January 2006, when the trading volume was at its peak, Murphy traded between 4,000 and 8,000 contracts per month. His trading included short-term option trades. Moreover, Murphy made more than one "round-trip" trade—a round-trip trade being when he returned to a flat position within a singular option series—within 59 different option series. For example, between December 2, 2002, and March 28, 2003, Murphy effected 11 round-trip trades of P&G 2004 January 90 call options, which generated $65,746 in trading losses, including $38,746 in commissions.[12] As another example, between August 5, 2004 and January 5, 2005, Murphy effected 11 round-trip trades of P&G 2005 January 55 call options, which generated $74,162 in trading losses, including $34,142 in commissions.

Moreover, during the relevant period trading losses began to increase, and a sizeable margin debit balance emerged. From October 31, 2003, until February 28, 2006, AL consistently ran a margin debit balance, with month-end margin debit balance amounts ranging from as low as $129,261 (on December 31, 2003) to as high as $1.16 million (on July 31, 2005).[13] AL ultimately paid a total of $125,034 in margin interest.

As a result of the commissions and margin interest, from July 2002 through February 2006, the annualized cost-to-equity ratio—the amount the account would have to appreciate simply to break even—was 25.59%.[14] The cost-to-equity ratios were even higher over certain periods of time: 31.25% in 2004, and 48.56% in 2005.

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[11] One equity option contract usually represents 100 shares of the underlying stock. *Thomas J. Furnari*, 47 S.E.C. 1074, 1075 n.2 (1984); *see also* The Options Industry Council, "*What Is an Option*," Part 1, http://www.optionseducation.org/basics/whatis/what_is_1.jsp#equity_options.

[12] The P&G options transactions will be described in this decision as follows: [quantity, if applicable] P&G [expiration year and month] [strike price] [call or put option]. Thus, "P&G 2004 January 90 call options" refers to an unspecified amount of Proctor & Gamble call options expiring in January 2004 at a strike price of $90.

[13] Murphy used margin to cover trading losses and send funds to AL.

[14] *See William D. Hirsh*, 54 S.E.C. 1068, 1073 n.7 (2000) ("The break-even return ratio (or cost-to-equity ratio) is the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses."). Without taking margin interest into account, the annualized cost-to-equity ratio for the same time period was 22.75%.

In addition, under Murphy's management the nature of the trading in AL's account changed and did not adhere either to AL's expressed wishes or to approved options levels set by the Firm. AL's instructions were to engage only in a covered call strategy, and her option agreement approved AL's account only for "covered writing" and "buying" of stock options prior to November 1, 2004.[15] Despite the restrictions that AL communicated, within days of Murphy's assignment to the account he began effecting options trades *besides* covered calls. He wrote uncovered calls,[16] wrote short puts,[17] held long calls,[18] and wrote short combination positions.[19] Murphy's trading beyond the "covered call strategy" that AL requested was frequent and flagrant. From July 2002 through October 2004, AL held options positions—often hundreds of contracts—that were not covered calls at the end of *each and every month* and held at least one uncovered call, short put, or short combination on 277 trading days. Sometimes, AL held various kinds of options simultaneously.

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15 On November 1, 2004, AL re-signed her *original* option agreement because she had recently re-married, and someone at BIS instructed her to change her name on her account. AL believed that, other than the name change, her option agreement was otherwise unchanged. However, at some point—either before or after AL signed—the option agreement was altered such that the boxes next to "uncovered writing" and "spreading" in the section titled "type of option writing" were checked and initialed "CB." The parties stipulated that it was Birkelbach who approved AL's account for uncovered options writing, and Birkelbach's testimony suggested that he could have made such approval after AL had re-signed the option agreement. AL testified that neither Murphy nor Birkelbach informed her that her account was being approved for uncovered writing and spreading.

16 An "uncovered call" involves selling (writing) call options without owning the underlying security. *See Furnari*, 47 S.E.C. at 1075.

17 A "short put" is selling (i.e., writing) an option that gives the holder the right to sell the underlying security at a stated price. In these proceedings, the short puts were all "uncovered," which meant that AL had neither cash deposited that was equal to the option exercise price to secure the put (i.e., a "cash-secured put") nor a corresponding short position in the underlying security. *See Characteristics and Risks*, *supra*, at 64-65; The Options Industry Council, *Understanding Equity Options* 30 (Sept. 2007) [hereinafter *Understanding Equity Options*].

18 A "long call" position is holding an option that gives the holder the right to purchase the underlying security at a stated price. *See* CBOE, *Equity Option Strategies – Buying Calls*, http://www.cboe.com/Strategies/EquityOptions/BuyingCalls/part1.aspx (explaining that a long call is buying an equity call option).

19 "Combination positions are positions in more than one option at the same time." *Characteristics and Risks*, *supra*, at 1. They also have been described as "the purchase or sale of both puts and calls." *Furnari*, 47 S.E.C. at 1075 n.2. An example of a "short combination" is short calls and short puts with the same expiration date but a different strike price.

Murphy recommended all the option trades in AL's account. Murphy did not talk to AL, however, before executing each trade. Instead, he spoke with AL about once a month when Murphy began managing her account and about once a week toward the end of his assignment.

Through most of the relevant period, Murphy led AL to believe that her account was profitable and that he was adhering to a covered call strategy. AL relied on Murphy's assurances that "everything was fine, that [she] was making a profit, that everything was okay." Although AL received account statements, she did not regularly review them or understand them when she did, and she let Murphy know that.

In the first quarter of 2005, AL began to learn that Murphy's assurances of profitability were false. At that time, Mark Pesavento ("Pesavento"), AL's accountant, was preparing AL's tax returns and informed AL that she had incurred a substantial loss in her BIS account exceeding $300,000 and that "the margin had somehow grown huge." "[A]larmed and upset" by this news, AL questioned Murphy, who tried to reassure her with an explanation that AL did not understand.[20] In or about April 2005, AL began to have meetings with Murphy, Pesavento, and DeRose. In those meetings—occurring at a time when AL's margin debit balance was "close to a million dollars"—AL instructed Murphy to "be conservative and stop the bleeding, get this interest down and stop losing money[,] . . . make some covered calls . . . and collect the premiums and then let the [P&G] stock get called away," which was the first time she expressed a willingness to sell her P&G stock. In May 2005, the Firm began to send duplicate copies of AL's account statements to Pesavento and DeRose.

In December 2005, AL learned from Pesavento that Murphy had continued to heavily trade her account. Also that month, FINRA, which earlier in the year had begun investigating Murphy's conduct, contacted AL to discuss the trading in her account. In a letter dated January 17, 2006, AL instructed Murphy to cease "option trading of any kind" except to "close out any remaining options as you need to." In March 2006, AL transferred the assets in her BIS account to her Fidelity account, and in April 2006 she closed her BIS account. In the end, Murphy's options trading generated losses totaling $871,301.95[21] and commissions totaling $1,002,100. From the third quarter of 2002 through the end of 2005, options trading in AL's account accounted for 59% of Murphy's overall commissions and 18% of BIS' total revenues.

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20 AL testified that Murphy explained that the margin debit balance "wasn't a true indication" of the margin because "monies had come from the margin in order to fund the covered calls" and also because it reflected, in part, a "loan, a home equity line of credit" that AL had borrowed.

21 This figure is calculated as follows. During the entire life of AL's BIS account, her option trading losses totaled $881,952.76. Subtracting from this figure the $10,650.81 in trading losses she incurred during Jage's management of the account (which involved options trading almost exclusively), the losses attributable to Murphy's option trading totaled $871,301.95.

4. Misleading Communications Between Murphy and AL

During Murphy's management of AL's account, Murphy caused various communications to be created and sent to AL, including 16 "profit and loss" statements, a report showing the "change in account value" for AL's margin account, and a document titled "safe option strategies that can be employed."

Each "profit and loss" statement purported to list, for the period of time covered in each statement, each options purchase and sale and any resulting realized profit and loss, both by series and in total. As further explained in the discussion section below, such profit and loss statements were riddled with errors, including numerous profit calculations that were overstated.

The "change in account value" report was a single document concerning AL's account that purported to show, for the years 2001 through 2005, the "starting value," "ending value," and "change in account value." As explained in the discussion section below, the report calculated the yearly account value changes in an inconsistent manner, which in turn caused the report to reflect incorrect changes in AL's account value.

The "safe option strategies" document was presented to AL at a meeting. The document identified several purportedly "safe" options strategies, including "collar options" and "short straddles." As explained in the discussion section below, the document described such strategies inaccurately and presented the attendant rewards and risks in an unbalanced manner.

B. The BM Account

BM opened an account at the Firm in May 1999, when he was a college student studying orchestral clarinet in Chicago, Illinois. BM opened his account with Langlois, BIS's compliance officer, whom BM had met while doing fundraising work for a symphony orchestra. BM's new account form showed that he was single, had one year of investment experience, an annual income of $15,000, and a liquid net worth of $2,300. It listed his investment objectives as long-term growth and short-term trading and risk exposure as speculation. BM testified that, under Langlois' management, he would purchase low-priced stocks and hold them until there was a significant change in the price, sometimes for up to two years. BM also testified that, at some point, he had given Langlois written discretionary authority. Between 1999 and 2001, BM deposited approximately $2,500 into the account, and did not thereafter deposit any amounts. At the end of March 2007, nearly eight years after he opened the account, BM's account was invested in five stocks and worth $18,546.83.

In April 2007, Langlois left BIS, and Birkelbach assigned BM's account to Murphy without BM's knowledge or approval. Murphy never asked BM if there had been any important changes in BM's life since he had opened the account, of which there were several. Specifically, BM had become an active member of the United States military, was stationed in Germany, had gotten married, was receiving $32,000 in annual income, and had a net worth of approximately $50,000.

Murphy served as BM's registered representative for just three months, from mid-April 2007 through mid-July 2007. During that time, Murphy never called BM, but BM called Murphy three times. The first phone call was placed in April 2007, soon after BM learned of the account transfer. During that call, Murphy proposed to "handle the account differently than . . .

Langlois had" and to use a "little more conservative approach . . . and not deal with penny stocks." BM testified that he told Murphy "that it sounds like a reasonable approach" but also said "I just want to think about this and I'll get back to you." BM did not give Murphy discretionary authority to trade his account, either in that first conversation or any time thereafter, and BM's account was never approved for discretionary trading.

In late May 2007, BM received his April 2007 statements and confirmations, the delivery of which had been delayed due to his overseas location. Upon receiving such materials, BM discovered that although he had not authorized any trades, Murphy had executed dozens of transactions in late April 2007, including liquidating four of the five stocks in the account and effecting in-and-out trades in three other stocks over a five-day period. Moreover, as of the end of April 2007, BM's account value had dropped to $15,387.34, which was a 17% percent drop in a single month. In April 2007 alone, BM incurred $2,132 in costs.

In late May or early June 2007, BM placed his second call to Murphy. BM asked Murphy to explain why his account had been traded at all. BM also complained that the commissions were "way, way higher" than he had paid with Langlois. BM testified that, in response, Murphy "made it seem like it had been a misunderstanding" and offered to refund $3,000 in commissions. Murphy also told BM that the account was worth about $13,000. BM told Murphy that he wanted to transfer his account to Langlois, who had moved to a different firm, and that he did not want Murphy to continue trading. BM also explained to Murphy that his overseas location caused a delay in his receipt of mail correspondence.[22]

Unbeknownst to BM, who had not yet received his May 2007 statement, the situation was worse than he realized. Throughout May 2007, Murphy had continued to trade in and out of numerous stocks, purchasing and liquidating six separate stocks within one to four days, incurring trading costs and, in most instances, trading losses. By May 31, 2007, BM's account value had dropped to $10,134.46—a 45% drop in value in just two months. In May 2007, BM had paid $3,257 in costs.

On July 9, 2007, after BM received his May 2007 statement, BM called Murphy and Birkelbach to complain. BM's primary concerns were that Murphy had made numerous unauthorized trades, that his account was worth less than Murphy had led him to believe during his previous call, and that the Firm had reimbursed him less in commissions than he was expecting. In July 2007, BM closed his BIS account and transferred his assets to Langlois' new firm. On July 12, 2007, BM sent a letter complaining about Murphy's handling of the account to FINRA and the Illinois Securities Department, with a copy to Birkelbach.

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22 In an on-the-record interview, Birkelbach testified that he had also spoken with BM on June 12 and 14, 2007. Birkelbach testified that during those conversations he offered to cut BM's commissions "in half" and that subsequently Murphy offered to reimburse BM approximately $1,700 in commissions. Birkelbach also claimed that he had no concerns at that time about the frequency of the trading in BM's account.

During the three months Murphy managed BM's account, Murphy effected numerous trades of 14 different stocks. The annualized turnover ratio was 22.62, and the annualized cost-to-equity ratio was 169%. BM paid approximately $5,395.77 in commissions and sustained losses of approximately $5,703.59 from the trading Murphy effected. BM had not authorized any of the trades in the account.

C. Supervision

Birkelbach had supervisory responsibilities concerning Murphy's handling of AL's account. As the Firm's SROP and CROP during the relevant period, Birkelbach was responsible for approving options agreements, including approving customers to engage in various levels of options trading. All options trades required his approval, and he reviewed the options trades on a daily basis to determine suitability and if the size and the frequency were appropriate. The parties stipulated that Birkelbach also reviewed the "profit and loss" reports and any "sales literature" that Murphy sent to AL. It is also undisputed that Birkelbach was responsible for supervising Murphy's trading of BM's account.

Langlois, the Firm's compliance officer from October 2001 through April 2007, had some supervisory responsibilities pertaining to Murphy's trading of AL's account. At the end of each trading day, Langlois reviewed trades to determine if they were suitable and authorized, including the options trades in AL's account. Langlois, however, was not a registered options principal, and he testified that he was not reviewing the suitability of the options trades in "a determinative sense." Langlois further explained that the options trades he reviewed would "go into a batch" and would be further reviewed the following day by Birkelbach, who had final approval of the suitability of options trades. Langlois also testified that all outgoing correspondence had to be reviewed either by Birkelbach or himself.

As explained in more detail below, Birkelbach was aware of numerous "red flags" concerning Murphy's trading of AL's and BM's accounts, but he took little supervisory action.

D. Settlements with Customers

At some point, AL filed an arbitration action against respondents. On April 2, 2007, respondents agreed to settle that action for $150,000. The settlement agreement contained a confidentiality provision that provided as follows:

> [AL] acknowledges that there is currently an investigation of the Respondent Parties, by NASD-Regulation, Inc., and should this investigation evolve into a formal administrative disciplinary proceeding against one or more of the Respondent Parties, [AL] will only provide testimony or documents under subpoena, or other lawful process.

On July 9, 2007, BM called Birkelbach to complain about Murphy's handling of his account. On July 12, 2007, BM sent to Birkelbach a written complaint. In January 2008, BM agreed to settle his dispute with Murphy, Birkelbach, and BIS for $4,758.05, which represented a

$3,000 payment plus $1,758 in commissions that purportedly had already been credited back to BM's account.[23]

III. Procedural History

The investigation that led to this proceeding began in November 2005, after a routine examination of BIS in which staff of FINRA's Department of Member Regulation reviewed trading that had occurred in AL's account. On August 1, 2008, Enforcement brought the nine-cause complaint that commenced this proceeding. Respondents filed an answer that generally denied the allegations and raised several affirmative defenses. On May 6, 2010, the Hearing Panel issued its decision, making the findings and imposing the sanctions as described above.[24] The Hearing Panel declined Enforcement's request to order restitution, noting that respondents had entered into settlements with the customers at issue. This appeal followed.[25]

IV. Discussion

A. Discretionary Trading Without Authorization

The Hearing Panel found that Murphy engaged in discretionary trading without written authorization from his clients or his Firm, in violation of NASD Rules 2510, 2860, and 2110. We affirm.

As the SEC noted in another disciplinary proceeding involving Murphy, "[d]iscretionary trading in a customer's account is a practice that is inherently susceptible to abuse." *William J. Murphy*, 54 S.E.C. 303, 307 (1999). The Commission continued, "[s]pecific advance authorization and approval [of discretionary trading] is important to assure a firm that the trading is being done with the consent of the customer and to alert the firm that extra oversight of the sales representative's handling of the account may be necessary to protect against improper or unsuitable trading." *Id.* NASD Rule 2510(b) provides, in pertinent part, that "[n]o member or

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23 Although BM acknowledged in the settlement agreement that he had received a $1,758 credit to his BIS account, FINRA investigator Julie Murphy testified that the Firm had only credited back $1,428.54.

24 In making findings, the Hearing Panel made express and implied credibility determinations. The Hearing Panel expressly stated that it did not find Murphy to be a credible witness, but that it found BM to be a "very credible" witness. The Hearing Panel made no express credibility findings with respect to AL, but it relied on many aspects of her testimony. The Hearing Panel made no express credibility findings with respect to Birkelbach, but the Hearing Panel did not rely on any of his testimony except for statements that he made against his own interest. The Hearing Panel made no express credibility findings with respect to any of the other witnesses, but it did cite and rely on certain testimony of Langlois, Pesavento, DeRose, Julie Murphy (a FINRA investigator), and Marc Allaire, Enforcement's expert witness.

25 On appeal, Murphy moved to introduce additional evidence in support of his argument that he is unable to pay any monetary sanction. That evidence is discussed below in Part V.1.c.

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 member, as evidenced in writing by the member." NASD Rule 2860(b)(18)(A) provides that a representative may not exercise discretionary power with respect to trading options contracts in a customer's account unless it complies with NASD Rule 2510, the customer's written authorization specifically authorizes options trading, and the account is accepted in writing by a Registered Options Principal.[26] The record amply demonstrates that Murphy violated these rules.

AL and BM did not give Murphy written authority to make trades, and AL's and BM's accounts were not approved by the Firm in writing for discretionary trading. Despite lacking such written authorization and approval, Murphy exercised discretion in AL's and BM's accounts. He traded options in AL's account and stocks in BM's account without first contacting such customers to obtain their approval of specific transactions and, as explained in Part IV.B below, effected unauthorized trades. *Cf. Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *34-35 (Nov. 8, 2006) (representative exercised discretion where he purchased stock without the customer's knowledge or written authorization of a specific order for purchasing a definite amount of stock), *aff'd*, 304 F. App'x 883 (D.C. Cir. 2008).

Asked at the hearing why he did not obtain written discretionary authority from AL, Murphy first testified "I didn't think it was necessary" before acknowledging that "[i]t's supposed to be in writing." Despite that apparent concession, respondents argue that Murphy's pre-January 31, 2005 trades in AL's account fell within the "time and price discretion" exception to NASD Rule 2510, as it existed prior to January 31, 2005.[27] There is no evidence, however, that Murphy and AL discussed time limits or price ranges with respect to specific orders, let alone which specific options series or quantities to purchase or how frequently to trade. Instead, Murphy discussed with AL only her overall request to execute a covered call strategy. Such general strategy discussions did not establish time and price discretion. *See Sathianathan*, 2006 SEC LEXIS 2572, at *34; NASD Rule 2510(d) (2004) (restricting the time-and-price-discretion exception to orders for the purchase or sale of "a definite amount of a security"). Moreover, although Murphy made numerous trades that were not covered calls, he and AL never discussed effecting any such options trades (as explained more in Part IV.B below), let alone any

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[26] It is a "long-standing and judicially-recognized policy that a violation of another Commission or NASD rule or regulation . . . constitutes a violation of . . . [NASD] Rule 2110." *Stephen J. Gluckman*, 54 S.E.C. 175, 185 (1999).

[27] Prior to January 31, 2005, NASD Rule 2510(d) provided that Rule 2510 did not apply to "discretion as to the price at which or the time when an order by a customer for the purchase or sale of a definite amount of a security shall be executed." On January 31, 2005, that exception was amended to state that "time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer." *NASD Notice to Members 04-71* (Oct. 2004).

parameters that governed the time and price limitations on executing such trades. We therefore reject respondents' argument that any of Murphy's trading fell within the time and price discretion exception.

Respondents also argue that AL verbally gave Murphy discretionary authority to trade her account, and that he misunderstood that BM had verbally given Murphy discretion to trade his account. To the extent that respondents are contending that such facts excuse Murphy's discretionary trading violations, they do not. The rules at issue do not permit discretionary trading based solely on verbal authorization.

For these reasons, we find that Murphy engaged in discretionary trading without the required approvals and authorizations, in violation of NASD Rules 2510(b), 2860, and 2110.

B. Unauthorized Trading and Trading Beyond Approved Levels

The Hearing Panel found that, from August 2002 until November 1, 2004, Murphy engaged in unauthorized trading and traded beyond approved levels in AL's account by effecting uncovered options trades, in violation of NASD Rule 2110. We affirm.

NASD Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and equitable principles of trade." Among such standards and principles, an associated person is "responsible for obtaining his [or her] customer's consent prior to purchasing a security for the customer's account." *Wanda P. Sears*, Exchange Act Rel. No. 58075, 2008 SEC LEXIS 1521, at *6 (July 1, 2008) (quotation omitted). Unauthorized trading is "a serious breach of the duty to observe high standards of commercial honor and just and equitable principles of trade." *Id.* at *6 (*quoting Bradley Kanode*, 49 S.E.C. 1155, 1156 (1989)).

Enforcement's claim that Murphy "traded beyond the approved level" also encompasses its allegation that Murphy engaged in options trades that his *Firm* had not categorically approved in AL's options account. While we are aware of no prior cases that specifically address whether such conduct is a stand-alone violation of Rule 2110, we hold that it can be in certain circumstances. Such conduct is essentially analogous to other prohibited conduct, such as unauthorized trading and making private securities transactions without a firm's written approval, and is inconsistent with high standards of commercial honor and just and equitable principles of trade.

The record amply demonstrates that Murphy engaged in unauthorized trading and trading beyond the approved levels. AL sought only a covered call strategy in her BIS account. Respondents stipulated that Murphy told AL he would effect a covered call strategy. Until November 1, 2004, AL's option account opening documents reflected that she sought, and that Birkelbach approved, only two categories of options trades: "covered writing" and "buying of stock options." The box next to "uncovered writing" was unchecked. Despite these limitations, Murphy did not limit his trading to covered writing but, instead, wrote numerous uncovered options.

Respondents concede that "some option trades . . . were technically outside the unchecked boxes on the [options agreement]" but nevertheless argue that all such option trades were authorized, approved, and even "insisted upon" by AL. In this regard, respondents argue that AL told Murphy she wanted to generate $10,000 in monthly income and did not want her P&G stock sold and that such "requirements generated the activity" in her account.

The factual premise on which these arguments rest is flawed. AL flatly *denied* that she ever told Murphy she wanted to generate $10,000 in monthly income. Murphy testified that she did make such an income demand, but the Hearing Panel expressly found that he was not a credible witness and made no findings that AL asked for $10,000 in monthly income. Respondents challenge that credibility determination, but they fail to point to substantial evidence to warrant overturning it.[28] In any event, the factual dispute over whether AL made a specific $10,000 income demand is entirely besides the point. AL specifically authorized *only* covered calls. If Murphy was unable to meet any purported income demands employing only covered calls, that did not give him the authorization—either from AL or the Firm—to effect uncovered options trades.

In further defense, Murphy argues that AL "never expressed a concern about the type of options transactions effected." Even if technically true, that would not excuse Murphy's unauthorized trades.[29] Even "after-the-fact acceptance of an unauthorized trade does not transform that transaction into an authorized trade." *Sandra K. Simpson*, 55 S.E.C. 766, 792

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28 For example, respondents claim that Murphy's testimony was supported by an April 9, 2004 memorandum prepared by DeRose, AL's financial planner, memorializing a meeting in which AL said she "want[s] to be financially independent with annual income of $120,000." Nothing in the memorandum, however, states that AL had made any such specific demands of Murphy. Indeed, AL testified that, at the time of her meeting with DeRose, she was planning on living with her new husband "who has a very nice income," and that she had never told DeRose that she "needed" $120,000.

In another example, respondents imply that AL's income needs were large by repeatedly noting that AL's children attended private school. AL testified, however, that her parents paid for that tuition.

Respondents also claim that Murphy's testimony was supported by evidence of AL's cash withdrawals and gross income. In this regard, respondents note that: (1) from October 30, 2001, to December 7, 2004, BIS issued checks to AL totaling $528,793, which were often in $10,000, $15,000, or $20,000 amounts; and (2) from 1998 through 2004, AL's tax returns sometimes reported adjusted gross income amounts exceeding $200,000 to $400,000, from which respondents infer both that AL must have liquidated P&G stock and that P&G dividends were "no longer sufficient to sustain her . . . lifestyle." There is no evidence, however, that such information reflected anything about what, if anything, she instructed Murphy concerning her income desires or needs for her BIS account.

29 AL did express a *general* concern about the overall activity in her account. When AL received from the Firm an "activity letter" dated November 11, 2003, showing that she had paid year-to-date commissions exceeding $250,000, AL was concerned and contacted Murphy. AL was appeased only because Murphy falsely told her that the commissions "didn't matter."

(2002) (internal quotation marks omitted). Moreover, considering AL's lack of investing sophistication, Murphy's repeated false assurances that her account was profitable, and the fact that AL ultimately filed an arbitration claim, any absence or delay in AL's complaints was "a consequence of misplaced trust" in Murphy "rather than approval of his actions." *Edgar B. Alacan*, Exchange Act Rel. No. 49970, 2004 SEC LEXIS 1422, at *21 (July 6, 2004).

Throwing even more blame AL's way, respondents argue that a portion of the uncovered positions were inadvertently caused by AL, when she pledged 13,600 shares of P&G stock to secure a $500,000 bridge loan. Even if true—and we see limited evidence to support it[30]—the argument is a red herring. Prior to when AL pledged stock to secure the bridge loan in June 2004, Murphy had already effected numerous uncovered calls.

Accordingly, we affirm the finding that Murphy engaged in unauthorized trading and trading beyond the approved level in AL's account, in violation of NASD Rule 2110.[31]

C. Excessive Trading, Churning, and Unsuitable Recommendations

The Hearing Panel found that Murphy engaged in unsuitable trading in violation of NASD Rules 2310, 2860, 2110 and IM-2310-2 because he engaged in an excessive number of options transactions in AL's account and stock trades in BM's account ("quantitative unsuitability") and effected options trades for AL while failing to have reasonable grounds to believe that they were suitable for her ("customer-specific unsuitability"). In related findings, the Hearing Panel found that the volume of Murphy's trading in AL's and BM's accounts constituted churning, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, NASD Rules 2120, 2310, and 2110 and IM-2310-2.

We analyze these issues in three parts. First, we consider the findings that Murphy engaged in excessive trading and churning in both accounts, findings that are closely related. We then address the findings that Murphy also violated his customer-specific suitability obligations in AL's account. We then address a number of Murphy's defenses that apply commonly to all these findings. As explained below, we affirm the Hearing Panel's findings of violations.

1. Excessive Trading and Churning

NASD Rule 2310(a) provides that "[i]n recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by

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30 The transfer of P&G shares for purposes of securing AL's bridge loan occurred in June 2004, and AL maintained only *one* uncovered call position between June 1, 2004 and November 1, 2004.

31 Our finding that trading beyond the approved levels set by a member firm violates NASD Rule 2110 is limited to the facts and circumstances of this case, which shows that Murphy consciously disregarded those approved levels.

such customer as to his other security holdings and as to his financial situation and needs."[32] NASD Rule 2860(b)(19) contains heightened suitability obligations when recommending options contracts. Among the obligations under such suitability rules is "quantitative suitability," which focuses on "whether the number of transactions within a given timeframe is suitable in light of the customer's financial circumstances and investment objectives." *Medeck*, 2009 FINRA Discip. LEXIS 7, at *32. To demonstrate quantitative unsuitability (also referred to as "excessive trading") requires proof of two elements. The first element is "broker control over the account in question." *Id.* at *34 (footnotes omitted). The second element is "excessive trading activity inconsistent with the customer's financial circumstances and investment objectives."[33] *Id.*

Excessive trading is closely related to, but distinct from, churning. Churning exists where excessive trading involves fraud. *Id.* Thus, to prove that excessive trading amounts to churning, scienter must be shown. *Id.*; *Simpson*, 55 S.E.C. at 796; *Donald A. Roche*, 53 S.E.C. 16, 22 (1997).[34]

As explained below, the record amply shows that Murphy controlled AL's and BM's accounts, that there was excessive trading activity inconsistent with such customers' financial circumstances and investment objectives, and that Murphy excessively traded the accounts with scienter.

a. Control

A broker's control over the account in question "is satisfied if the broker has either discretionary authority or *de facto* control over the account." *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34 (footnotes omitted). "Control may be established where a customer, although not granting his broker a formal power of attorney, so relies upon the broker that the latter is in a position to control the volume and frequency of transactions in the account." *John M. Reynolds*, 50 S.E.C. 805, 807 (1991).

Murphy controlled AL's and BM's accounts. AL, who trusted Murphy to handle her account consistent with her objectives and needs, verbally gave Murphy discretion to trade her account to effect covered calls. Murphy proceeded to exercise that discretion to make scores of

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32 NASD Rules that apply to members, such as NASD Rule 2310, apply with equal force to FINRA members and their associated persons. NASD Rule 0115(a).

33 Any violation of the suitability rule also requires proof that there was a "recommendation." When a broker exercises discretion to make trades or engages in unauthorized trading, as Murphy did, such trades are considered to be implicitly recommended for purposes of the suitability rule. *Medeck*, 2009 FINRA Discip. LEXIS 7, at *35 n.14 (citing *Rafael Pinchas*, 54 S.E.C. 331, 341 (1999), and *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992)).

34 Excessive trading and churning also violate a registered representative's responsibility of fair dealing. *See* IM-2310-2(b)(2).

trades without contacting AL first. AL lacked the investment experience and sophistication to understand the complex options trading that Murphy was effecting. Moreover, as explained above, many of Murphy's options trades were not covered calls and were, therefore, unauthorized. With respect to BM's account, BM never gave Murphy discretion, either verbally or in writing, to trade his account. Nevertheless, without BM's knowledge or approval, Murphy traded BM's account as if he had discretion, liquidating the stocks that BM held when Murphy took over the account, and proceeding to in-and-out trade a number of other stocks before BM called a halt to it.

Such circumstances demonstrate that Murphy controlled AL's and BM's accounts. *Cf. Simpson*, 55 S.E.C. at 796 (finding de facto control where broker made "many unauthorized transactions" and where the customers had a "general lack of investment knowledge and sophistication" that "left control in the hands of [the broker]"); *Gerald E. Donnelly*, 52 S.E.C. 600, 603-04 (1996) (finding that broker controlled account where he "exercised discretionary authority in 20 percent of the transactions" and where customers approved other transactions "simply on the basis of the broker's recommendations"); *see also Reynolds*, 50 S.E.C. at 807-08.

b. Excessive Activity

Having established the element of control, we next turn to whether there was excessive trading activity inconsistent with AL's and BM's financial circumstances and investment objectives. The "assessment of the level of trading . . . does not rest on any magical per annum percentage, however calculated." *Donnelly*, 52 S.E.C. at 603 (internal quotation marks omitted). Nevertheless, "[a]lthough there is no single test for what constitutes excessive activity, factors such as turnover rate, cost-to-equity ratio, and use of 'in and out' trading in an account may provide a basis for a finding of excessive trading." *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34-35.

AL sought income, long-term growth, and a moderate amount of risk. She did not want to sell her P&G stock, which was her primary source of income. AL was an inexperienced investor, and she did not understand options trading. The level that Murphy traded AL's account was wildly inconsistent with her financial circumstances and objectives. From July 2002 through February 2006, Murphy traded 67,000 options contracts in AL's account in approximately 2,600 transactions. During that period, the annualized cost-to-equity ratio—the amount the account had to appreciate to break even—was 25.59% (22.75% without accounting for margin interest). The cost-to-equity ratios were even higher during shorter periods of time: 31.25% (27.78% excluding margin interest) during 2004, and 48.56% (39.32% excluding margin interest) in 2005.[35] Given AL's declared strategy of covered calls and moderate risk, we find

[35] Where options trading is involved, as is the case in AL's account, the cost-to-equity ratio is a "better measurement[ ]" of excessive trading than the turnover rate. *Medeck*, 2009 FINRA Discip. LEXIS 7, at *45 (citing, *inter alia*, Report of the Special Study of the Options Markets to the SEC [hereinafter "Special Study"], H.R. Comm. Print IFC3, 96th Cong., 1st Sess., at 453-54 (1978)).

that the cost-to-equity ratio above 25% is completely excessive.[36] Lower cost-to-equity ratios than these have supported excessive trading findings in other cases.[37] In addition, Murphy executed more than one round-trip trade within 59 different options series. All of this evidence demonstrates that Murphy excessively traded AL's account.[38]

We reach the same conclusion for BM's account. When Murphy was assigned to that account, BM was 29 years old, he earned an annual salary of $32,000, and his BIS portfolio was worth $18,546. In their first conversation, Murphy told BM that he wanted to use a "little more conservative approach . . . and not deal with penny stocks." BM, while indicating that he wanted to think about it, responded that that "sounds like a reasonable approach."[39] The amount that Murphy traded BM's account was inconsistent with his modest financial circumstances and the discussed investment approach. During the nine months that preceded Murphy's assignment to the account, BM engaged in a modest amount of buying and selling stocks, effecting 15 trades in

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36 As Enforcement's expert witness testified, a typical covered call writing strategy is "not an active trading strategy. It's something you do two or three trades a month." Although other options strategies that involve higher volume trading and more risk will typically generate higher costs, we measure the costs in this case against what was suitable for AL's account.

37 *See, e.g.*, *Pinchas*, 54 S.E.C. at 340 (explaining that "[w]e have previously found that a cost-to-equity ratio in excess of 20% indicates excessive trading"); *Harry Gliksman*, 54 S.E.C. 471, 477 (1999) (finding that broker's trades for a conservative corporate investor were excessive where the annualized cost-to-equity ratio was 18%), *aff'd*, 24 F. App'x 702 (9th Cir. 2001); *Peter C. Bucchieri*, 52 S.E.C. 800, 801-03 (1996) (finding excessive trading where cost-to-equity ratios ranged from 20% to 30%).

38 *Cf. Clyde J. Bruff*, 50 S.E.C. 1266, 1270 (1992) (characterizing options trading as "highly aggressive" where it included "frequent transactions where positions were opened and closed within short periods of time, coupled with the use of naked options writing and complex strategies"); *see also David Wong*, 55 S.E.C. 602, 612 (2002) (finding that broker effected excessive options trades where, in a 16-month period, he effected 116 options trades for a customer with no options experience, who was unable to understand the risks, and who sought conservative investment objectives); *Dan Adlai Druz*, 52 S.E.C. 416, 418-21, 423 (1995) (finding that options trading for a customer who did not seek aggressive trading or to risk its principal, had goals of income and capital appreciation, and had no options experience was excessive where, in a one-year period, broker effected hundreds of opening options transactions, traded naked options, and generated a substantial percentage of broker's commissions), *aff'd*, 103 F.3d 112 (3d Cir. 1996); *see also Frank DeRose*, 51 S.E.C. 652, 659-60 (1993).

39 BM's favorable reaction to Murphy's proposal to use a "little more conservative approach" is the best gauge of BM's objectives when Murphy took over the account. Although BM's new account form indicated that BM's investment objectives included "short-term trading" and that his desired risk exposure level was "speculation," that document was completed eight years before Murphy's involvement and was not updated after BM's discussion with Murphy.

six different stocks. When Murphy took over, the volume of trading changed dramatically. In just three months, Murphy recommended and effected numerous trades in 14 different stocks, liquidated nearly all of BM's holdings, and engaged in in-and-out trading of numerous stocks. Murphy's trading yielded an annualized turnover rate of 22.62 and an annualized cost-to-equity ratio of 169%, both of which are *substantially* above the levels that have supported findings of excessive trading in other cases.[40] *See* n.37, *supra* (discussing cost-to-equity ratios); *Stein*, 56 S.E.C. at 118 ("Turnover rates between three and five have triggered liability for excessive trading, and it has been generally recognized that an annual turnover rate of greater than six evidences excessive trading.").[41]

Respondents argue that the 169% cost-to-equity calculation is unfair because it includes costs that BM incurred during Murphy's initial reallocation of BM's portfolio in April 2007. We are not aware of any cases, however, in which the costs of initial reallocating transactions within the relevant period were omitted from an excessive trading analysis. Moreover, we see no reason to omit such costs here, especially considering that Murphy lacked the authorization to effect any reallocating transactions in the first place.[42]

Respondents also argue that the annualized ratios concerning BM's account are not meaningful because his account was open for only three months. We do not believe, however, that three months is the kind of "particularly short" period that impacts the persuasiveness of the annualized turnover and cost-to-equity ratios. *See Medeck*, 2009 FINRA Discip. LEXIS 7, at *47-48 (directing Hearing Panel to consider "the limitations, if any, of [relying on annualized ratios] when the period in question is particularly short (approximately six weeks in this case)"); *cf. Dep't of Enforcement v. O'Hare*, Complaint No. C9B030045, 2005 NASD Discip. LEXIS 39, at *18 n.17 (NASD NAC Apr. 21, 2005) (expressly rejecting the argument that excessive trading allegations should cover a period of time greater than three months). Even if it did, the annualized ratios here are substantially above problematic levels and would remain indicative of excessive trading. *Medeck*, 2009 FINRA Discip. LEXIS 7, at *48 n.32 (directing that annualized figures might be of less weight "where they barely reach levels that would allow the trier of fact to otherwise make findings of excessive trading and the actual trading period is particularly brief"); *cf. O'Hare*, 2005 NASD Discip. LEXIS 39, at *13-17 (finding excessive trading over a three-month period where, among other things, the annualized cost-to-equity ratio was 140% and the annualized turnover rate was 21.358). Accordingly, we find that Murphy's trading of AL's and BM's accounts was excessive.

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40 In calculating the turnover ratio, Enforcement used the "modified Looper formula, dividing total cost of purchases by . . . average monthly investment or equity," and then annualizing the result. *Jack H. Stein*, 56 S.E.C. 108, 119 n.26 (2003).

41 Even if BM's objective was to speculate, as the account documents stated, the pace of trading was still unsuitable for someone with his modest financial circumstances.

42 Moreover, even if all the trading costs that BM incurred in April 2007 were excluded, our calculations show that the annualized cost-to-equity ratio would stand at 102%, still substantially above the levels that have supported a finding of excessive trading.

c. Scienter

Whether Murphy's excessive trading also amounted to churning depends on whether he acted with scienter. "Scienter requires proof that a respondent intended to deceive, manipulate, or defraud, or 'acted with severe recklessness involving an extreme departure from the standards of ordinary care.'" *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34. With regard to churning, scienter may be established by showing that "the activity and commissions were so unreasonable in light of the customer's investment objectives and financial situation that they evidence intentional misconduct or recklessness." *Id.* at *53; *see also Dep't of Enforcement v. Kelly*, Complaint No. E9A20004048801, 2008 FINRA Discip. LEXIS 48, at *18 (FINRA NAC Dec. 16, 2008) (holding that scienter "may be established by showing a broker's 'reckless disregard for the customer's interests'"); *Michael T. Studer*, Exchange Act Rel. No. 50543, 2004 SEC LEXIS 2347, at *16-17 (Oct. 14, 2004) (holding that churning occurs when a broker "manages a client's account for the purposes of generating commissions"), *aff'd*, 148 F. App'x 58 (2d Cir. 2005).

The record demonstrates that the volume of trading Murphy effected in AL's account was for the purpose of generating commissions and with reckless disregard of AL's interests. Over three and one-half years, Murphy's trading generated commissions exceeding $1 million, an astronomical figure for a customer whose account opening statements indicated she earned an annual income of only $50,000. The trading costs were so high that AL had to earn 25% over the life of the account simply to break even.

That Murphy was disregarding AL's interests must have been obvious to him. Trading AL's account became the primary source of Murphy's income for several years. Murphy traded the account on a substantial number of days and, from the third quarter of 2002 through the end of 2005, options trading in AL's account accounted for 59% of his commissions. Murphy knew that AL had not checked "short term trading" as an investment objective on her account opening documents, but short-term trading is exactly what he did. The excessiveness of the trading would have grown even more obvious as the margin debit balance grew to dangerous heights and the trading losses began to mount.

Further demonstrating his scienter, Murphy took numerous steps to mislead AL about his excessive trading. Throughout most of the relevant period, Murphy led AL to believe falsely that her account was profitable and that the commissions were of no concern. For example:

- Murphy falsely assured AL that "everything was fine, that [she] was making a profit, that everything was okay."

- Murphy minimized the import of "activity letters" AL had received from the Firm, all of which noted the large volume of options activity and one of which noted that AL had paid year-to-date commissions totaling $251,781. In this regard, Murphy told AL that such letters were "routine," "not to worry about [the commissions] because the account was profitable," and that the commissions "didn't matter."

- In a July 2, 2004 letter to AL, Murphy wrote that checks he had issued to AL since 2001 totaling $461,793 "represent dividends paid, profits from option trading and income from covered call options." This falsely implied that the account had been profitable when, in fact, it had already generated at least $275,782 in trading losses.

In defense, respondents note that duplicate account statements were sent to AL's accountants (first Richard How, then Pesavento) and her financial planner (DeRose), and argue that if Murphy was trying to churn he would "not so readily have shared all of the account data with [AL's] hired professionals." Duplicate account statements, however, were not sent to AL's accountant or financial planner between April 2003 and April 2005. Moreover, the fact that Murphy knew that AL's accountants and financial planners might be looking at AL's account statements does not preclude a finding of scienter. There is no evidence that AL retained her accountants and financial planner to monitor Murphy's trading or that she told Murphy she had. And even if Murphy believed he faced some increased risk in getting caught, that is not inconsistent with a finding that he was still trying to churn the account. Indeed, the blistering pace with which he traded leaves room for no other conclusion.

Murphy also had scienter in excessively trading BM's account. The 169% cost-to-equity ratio and turnover rate of 22 were so high that Murphy must have known he was acting in reckless disregard of BM's interests. That conclusion is bolstered considering that the $5,395.77 in commissions charged during the relevant three-month period was 42% of BM's average account equity and nearly 17% of his annual salary and that, under Murphy's management, BM's account value plummeted more than 45% in just two months. Such circumstances justify an inference that Murphy was acting merely to increase his own commissions.

Accordingly, Murphy excessively traded both AL's and BM's account with scienter and, accordingly, churned those accounts.

2. <u>Customer-Specific Suitability</u>

The Hearing Panel also found that Murphy's excessive trading and churning of AL's account included trades that violated the customer-specific suitability obligation.[43] We affirm.

The customer-specific suitability obligation required Murphy to have reasonable grounds to believe that his recommendations were suitable for AL. Because Murphy's trading of AL's account involved options, his customer-specific suitability obligation involved heightened responsibilities. As the SEC has explained, "options transactions involve a high degree of financial risk" and "[o]nly investors who understand those risks, and who are able to sustain the costs and financial losses that may be associated with options trading should participate in the listed options markets." *Patrick G. Keel*, 51 S.E.C. 282, 284 (1993) (internal quotation marks omitted) (quoting *Special Study*, at 1); *Bruff*, 50 S.E.C. at 1268.

AL was not such an investor. Notwithstanding her sizeable assets, AL was an inexperienced investor who did not understand options fundamentals and had no experience with short-term trading. AL thought she understood what a covered call strategy was, but she did not

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43 The complaint made no allegations that Murphy violated any customer-specific suitability obligations regarding BM's account.

understand that such a strategy includes only the use of covered calls (and liquidating transactions). Nor did she understand that the import of her request that her P&G stock not be sold or called away was that it left her with little other assets with which to endure market movements adverse to any covered call positions, and that the approach could lead to a "severe cash drain."[44] *Cf. DeRose*, 51 S.E.C. at 658 (finding that options trading was unsuitable where the customers "were unsophisticated investors with little experience in financial matters and even less knowledge of options" who "were totally unable to evaluate the risks inherent in options trading").[45]

Even if AL had understood the risks involved, Murphy had no reason to believe that the kinds of options transactions he effected were appropriate for AL's financial situation. AL expressly sought income, long-term growth, and exposure to only moderate risk. Although AL's assets were sizeable, she earned only a modest annual income, mostly from dividends paid on her P&G stock. Despite AL's financial situation and objectives, Murphy effected a variety of options trades (apart from the covered calls that AL had requested) that were highly risky.

First, Murphy wrote uncovered calls in AL's account, which were far too risky for AL. "[U]ncovered call writing can involve substantially greater exposure to risk than covered call writing." *Characteristics and Risks*, *supra*, at 13, 63. If the call option is exercised, the uncovered call writer "may have to buy stock in the market for more than the option's strike price" to satisfy the delivery obligation. *Understanding Equity Options*, *supra*, at 30; *Characteristics and Risks*, *supra*, at 63. "Uncovered call writing may result in very *substantial* losses if the market price of the stock underlying the call continues to rise above the exercise price of the call." *Thomas P. Garrity*, 48 S.E.C. 880, 881 n.3 (1987) (emphasis added); *see also*

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44 Marc Allaire, Enforcement's expert witness, explained how covered call writing with a restriction against selling the underlying shares can lead to a severe cash drain. In the event that the call options were exercised against AL, she would have been obligated to deliver P&G stock. To avoid such a delivery obligation, AL would have had to purchase back her covered calls before they were exercised. AL's request that her P&G stock not be sold or called away was even more problematic because she had limited other assets to fund buy-backs of covered calls or purchase any P&G stock needed to fulfill a delivery obligation. Such costs can be substantial if the price of the underlying stock rises strongly enough. Where available cash is limited, margin could be used, but that would lead to the payment of margin interest. Likewise, the buy-back of a covered call could be financed using premium income generated from writing a new covered call, but such "rolling" would require the additional payment of commissions.

45 Arguing that AL understood the risks involved with the covered call strategy, respondents note that, by the time she started working with Murphy, AL had already incurred losses under Jage. That argument is undermined by the record, which among other things shows that Murphy made statements to appease AL's concerns about the trading losses she had incurred with Jage. Moreover, AL had no history of trading the many options positions that Murphy effected that did *not* involve covered calls.

Ronald L. Brownlow, 47 S.E.C. 662, 664 n.2 (1981) (holding that naked call options "may theoretically involve unlimited losses") (citing *Special Study*, at 1).[46]

Murphy also sold short put options, which are also highly risky. Short puts may result in substantial losses if the market price of the underlying stock falls below the exercise price. *See Characteristics and Risks*, *supra*, at 64. In addition, writing puts on a stock one owns—as Murphy did with AL's account—increases exposure to downward movements in the stock price and, as Enforcement's expert witness testified, "makes no sense in a portfolio with a total lack of diversification." *Special Study*, at 94 ("[A] short put position . . . decrease[s] in value with the stock.").[47] And where short puts are *uncovered*—as they were in AL's account—the risks are even greater. *Understanding Equity Options*, *supra*, at 30; *Special Study*, at 114 ("The writer of uncovered [put] options can expect a profit limited to the amount of the premiums received, but . . . a loss which is limited only by the exercise price."); *see also Albert Vincent O'Neal*, 51 S.E.C. 1128, 1130 (1994) (describing investing in "naked options" as "speculat[ing] in high risk investments").[48]

Murphy also bought large numbers of long call options on P&G stock, which also were unsuitably risky for AL. A long call gives the option holder the right to buy a certain number of shares at a specified price on or before the stated expiration date. "If not sold or exercised before its termination date, [an option] will expire with a consequent loss to the investor of his entire investment." *Bruff*, 50 S.E.C. at 1270; *see also Special Study*, at 99 (explaining that a buyer of a call option is subject to the risk that the call option "would expire worthless and his whole investment would be lost"). Moreover, purchasing a long call in a portfolio that already holds a long position in such stock—as Murphy did—increases the exposure to that stock: should the

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46 Even the risk of partially uncovered call writing activities—in which the call writer owns underlying securities to cover a portion of a call—"depend[s] upon the use of a delta factor or hedge ratio which changes sometimes rapidly, so that to the extent the option position is uncovered the exposure is that of a writer of an uncovered option." *Special Study*, at 114.

47 AL's account was short 300 puts or more at month-end on eight different occasions during the relevant period. In just one shockingly risky example, at the end of August 2003, Murphy had established a short put position of 300 P&G 2006 January 80 puts. At the time, P&G stock was trading at $87.29, and AL's account was worth $1.481 million. If the price of P&G stock had dropped below $80 per share before the option expiration date, AL would have been obligated to purchase 30,000 shares of P&G stock for $2.4 million, an amount that would have greatly exceeded the value of her account and, depending on how far the price of P&G stock dropped, could have been far more than 30,000 shares were worth.

48 Writers of uncovered puts (and uncovered calls) also "may have to meet calls for substantial additional margin in the event of adverse market movements." *Characteristics and Risks*, *supra*, at 55, 64, 65; *see also* 7 Loss & Seligman, *Securities Regulation* 3276-77 (3d ed. 2003) ("Unlike stock purchases where margin finances a credit transaction, options margin is a type of performance bond for the possible obligations incurred if the underlying stock generates a loss for the options writer.").

stock price decrease, both the stock and the long call would lose value. *See Special Study*, at 94 ("A long call position . . . increase[s] and decrease[s] in value with the stock.") & 110 ("The purchase of calls increases the leverage and risks of a portfolio holding the underlying stock.").[49]

Murphy also effected complex options combinations that lacked any apparent justification. For example, at the end of January 2003, Murphy's trades resulted in AL holding 20,000 shares of P&G stock along with a dizzying array of P&G options including 200 covered calls, 100 uncovered calls, 200 long calls, and 300 short puts. As Enforcement's expert witness put it, the "complexity of this position . . . is totally, totally incongruous with [AL's] trading experience and investment objectives" and that "[i]f this looks like spaghetti . . . it is." Indeed, at the hearing Murphy himself was at a loss to explain how a similarly complex combination of option positions that AL held on December 4, 2002, would lead to profits. *See Characteristics and Risks*, *supra*, at 67 ("Combination transactions . . . are more complex than buying or writing a single option . . . . [A]s in any area of investing, *a complexity not well understood is, in itself, a risk factor*.").

These speculative options trades—alone, in combination, and in the context of a course of trading that was excessive—were unsuitable for AL. *Cf. O'Neal*, 51 S.E.C. at 1130 (holding that trading naked options for a customer who did not want to speculate in high risk investments was unsuitable); *Ivan M. Kobey*, 51 S.E.C. 204, 212-13 (1992) (risky options strategies, including position in naked options, were unsuitable for investor seeking conservative, growth-oriented objectives); *Bruff*, 50 S.E.C. at 1270 (frequent short-term options trading, coupled with the use of naked options writing and complex strategies such as spreads, "involved a high degree of financial risk and complexity" and was unsuitable considering that, inter alia, the customer "lack[ed] understanding of options").[50]

Further raising the stakes, the risks involved with Murphy's options trading were exacerbated by the sizeable margin debit balance that emerged in AL's account, which reached a high point of $1.16 million on July 31, 2005. "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." *F.J. Kaufman & Co.*, 50 S.E.C. 164, 165 n.1 (1989) (internal quotation marks omitted). Furthermore, "margin accounts are at risk to lose more than the amount invested if shares

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[49] One example demonstrates how Murphy established a long call position that, as Enforcement's expert witness put it, looked like "an act of desperation." In early December 2005, Murphy held 3,300 call options (expiring in either January or April 2006). Three thousand of those options were purchased during the first 12 days of December using $304,500 in borrowed funds, at a time when the total account value was worth only about $900,000. Enforcement's expert witness opined that this long call position "appear[ed] to be an attempt to make a large short-term gain," a "massive bet that P&G would rally strongly in the short term," and a "very speculative gamble [that] put at risk one third of the account's equity."

[50] Even *respondents'* expert witness, Thomas Haugh, opined that Murphy made options trades in AL's account that "were more speculative in nature than [a] covered call writing program."

depreciate sufficiently, giving rise to a margin call. If the customer has limited liquid assets available to meet these charges and risks, securities must be liquidated to cover them." *James B. Chase*, 56 S.E.C. 149, 157 (2003) (footnotes omitted); *see also David A. Gingras*, 50 S.E.C. 1286, 1288-89 (1992) (finding that the impropriety of recommended trading strategy was exacerbated by the use of margin trading).

In sum, Murphy's options trades were unsuitable because AL did not understand the risks involved, and because Murphy had no reason to believe that they were appropriate for AL's financial situation. Accordingly, Murphy's trading of options in AL's account violated his customer-specific suitability obligations.[51]

3. Defenses

Respondents raise a number of common defenses to the suitability and churning findings. None is persuasive.

Respondents argue that Murphy "attempted to . . . meet [AL's] dual objectives" of generating $10,000 a month income while preserving her existing P&G stock holdings. In this regard, they argue that Murphy wrote options that were "close to in the money" to generate the most income, note that their expert witness deemed the trading to be an "income maximizing program," and assert that AL's P&G stock was "virtually preserved in its entirety." Going so far as to claim that the volume of trading was "necessitated" by AL's instructions, respondents contend that AL's purported demands "put tremendous pressure on Murphy" and "account[ ] for Murphy's straying from the covered call option writing program to engage in more speculative option trading." Respondents argue that AL's goals were "lofty" but "not unsuitable" and that he "ended up falling into a trap many options traders fall into: chasing a number."[52]

These arguments—some of which have shifted over time[53]—offer no excuse for Murphy's unsuitable recommendations. As we explained above, the Hearing Panel did not credit

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51 The Hearing Panel also opined that even if Murphy had pursued only the strategy AL wanted—generating income through writing covered calls but without selling her stock—that such a strategy was "mission impossible." To the extent the Hearing Panel was finding that Murphy's effecting covered calls in AL's account was *per se* unsuitable, we do not reach that issue.

52 Respondents also argue that it was AL's idea to engage in a covered call writing strategy and that all Murphy was doing was following instructions. As we have already found, however, Murphy did not follow AL's instructions to trade only covered calls.

53 Respondents' current claim that Murphy aimed to write options that were close to in-the-money is the *opposite* of what Murphy previously claimed was his trading strategy. In an on-the-record interview, Murphy testified that he told AL he would "stay away from writing calls too close . . . to the strike" and recommended that she buy options that were "$5, $10" out of the money.

Murphy's testimony that AL asked him to generate $10,000 per month in income. Even if AL had informed Murphy to generate $10,000 of income in her BIS account without selling her stock, respondents have not demonstrated how Murphy's trading was designed to achieve such an income demand,[54] and their assertion that AL's P&G stock was preserved in its entirety is not factually accurate.[55]

But the critical flaw with respondents' arguments is that they offer no explanation—nor could they—how Murphy's excessive trading of highly speculative options, coupled with substantial margin, was consistent with AL's tolerance for only moderate risk. That Murphy may have been "chasing a number" did not permit him to engage in a course of trading that substantially exceeded AL's risk tolerance. *Cf. Dep't of Enforcement v. Cody*, Complaint No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *28 (FINRA NAC May 10, 2010) (finding that broker's belief that customer sought a "high return" did not permit broker to purchase non-investment grade bonds that exceeded the risk the customer was able and willing to take), *aff'd*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011); *Pinchas*, 54 S.E.C. at 342 (holding that a customer's "desire[ ] . . . to double her money . . . would not have relieved [broker] from his duty to recommend only those trades suitable to her situation"). Likewise, that AL sought to engage in covered call writing did not give Murphy license to engage in whatever trading he desired.[56]

Citing their own expert witness, respondents also argue that the "difficulties" Murphy encountered when trading AL's account were "mitigated by the profit and increased value of the [P&G] stock" and that it is "not fair to split the portfolio in half when considering returns." For liability purposes, our focus is on the suitability of Murphy's recommendations, not their end

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54 Although Murphy's writing of calls and puts generated premium income, it subjected AL to the risk—which would have been heightened for any close-to-the-money options AL wrote—of a substantial cash *drain* if prices moved against the positions, especially given that AL was unwilling to sell her P&G stock to fulfill any delivery obligations or finance any purchase obligations or buy-backs of options. Indeed, Murphy even conceded during an on-the-record interview that writing uncovered calls is not consistent with an "income strategy." Likewise, Murphy's purchasing of long calls required an initial outlay of cash, with the possibility that AL could lose the entire premium paid. Moreover, the huge commissions and margin interest payments saddled AL with even more cash outlay requirements.

55 Ultimately, in an effort to reduce the excessive margin debit balance that Murphy allowed to emerge, AL finally agreed to allow her P&G shares to be sold or called away. Between September 21, 2005, and January 20, 2006 (which was after AL's account had received a stock split in June 2004), Murphy sold 25,000 shares of P&G stock and purchased 9,500 shares, for a net sale of 15,500 shares.

56 Even if AL wanted to engage in highly speculative or aggressive options trading—which she did not—Murphy was "under a duty to refrain from making recommendations that are incompatible with the customer's financial profile." *Stein*, 56 S.E.C. at 113; *see also Bruff*, 50 S.E.C. at 1269.

result. *Stein*, 56 S.E.C. at 117 n.21 (holding that the fact that recommendations are profitable does not affect whether they were suitable).[57] For a similar reason, respondents' argument that many of the stocks that Murphy liquidated from BM's account "ended up losing most if not all of their value" is irrelevant.

Finally, respondents attempt to excuse Murphy's suitability and churning violations by pointing to others' purported inaction. For example, respondents assert that AL ignored her confirmations and monthly statements and did not contact the Firm with any questions in response to the "activity letters" that were sent to her. They also contend that although AL's financial planner, DeRose, and accountant, Pesavento, received copies of AL's account statements and attended various meetings with Murphy, they did not express any concerns. These arguments, however, suffer from factual flaws. AL *did* contact Murphy in response to some of the activity letters, only to have Murphy minimize them as routine and make false representations about the profitability of her account. *Bucchieri*, 52 S.E.C. at 805 (finding suitability violations where "customers . . . complained only to be told . . . that there was nothing to worry about"). Likewise, Birkelbach conceded during an on-the-record interview that DeRose *did* alert him that she thought the "activity was unusually high." Moreover, Murphy had no reasonable basis to expect DeRose or Pesavento to raise any concerns: DeRose had no expertise in options trading; Pesavento was not a licensed options principal and did not advise clients on options strategies; and neither DeRose nor Pesavento had or assumed any responsibility to assess the suitability of the trading. Regardless, the attempts to shift the blame are not only "completely irrelevant to [Murphy's] responsibility for his own misconduct" but an "indicia of his failure to take responsibility for his actions." *Clyde J. Bruff*, 53 S.E.C. 880, 887 (1998), *aff'd*, No. 98-71512, 1999 U.S. App. LEXIS 27405 (9th Cir. Oct. 18, 1999); *Stein*, 56 S.E.C. at 122 & n.37.[58]

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[57] It is appropriate to consider how an existing position in the underlying stock affects the suitability of a recommended options trade. As we have explained above, however, some of Murphy's options trading in AL's account was uncovered and some of it—the long calls and short puts—*increased* the exposure AL had to adverse movements in the price of P&G stock.

[58] Respondents contend that all causes of action stemming from the trading in AL's account are barred by the statute of limitations contained in 28 U.S.C. § 2462 because the alleged violations commenced more than five years before the complaint was filed. The Commission has held, however that there are no statutes of limitations that apply to self-regulatory organization proceedings and that 28 U.S.C. § 2462 does not apply to FINRA proceedings. *See Hirsh*, 54 S.E.C. at 1077; *Larry Ira Klein*, 52 S.E.C. 1030, 1039 (1996) ("We do not believe that [28 U.S.C. § 2462] applies to disciplinary proceedings brought by a self-regulatory organization.").

We are mindful that "under certain circumstances inordinate time delays can render a proceeding inherently unfair and be cause for dismissal." *Hirsh*, 54 S.E.C. at 1077. This proceeding, however, involves nothing that would rise to the level of "inordinate." Enforcement filed the complaint in July 2008, less than two and one-half years after the relevant trading in AL's account ended. Moreover, respondents make no argument concerning how they were

[Footnote continued on next page]

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Murphy excessively traded and churned AL's and BM's accounts and effected in AL's account unsuitably risky options trades that subjected AL to risks that went substantially beyond her moderate risk tolerance. Accordingly, Murphy violated his suitability obligations, in violation of NASD Rules 2310, 2860, and 2110 and IM-2310-2, and churned his customers' accounts, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, NASD Rules 2120, 2310, and 2110, and IM-2310-2.

D. Misleading Communications

The Hearing Panel found that Murphy caused the creation and distribution to AL of inaccurate, misleading, and unbalanced written communications, in violation of NASD Rules 2210, 2220, and 2110. We affirm.

NASD Rule 2210(d) governs content standards in communications with the public. NASD Rule 2210(d)(1)(A) provides that "[a]ll member communications with the public shall 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, industry, or service. 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." NASD Rule 2210(d)(1)(B) provides that "[n]o member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public." That rule further provides that "[n]o 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."[59] NASD Rule 2210(d)(1)(B).

NASD Rule 2220(d)(1) governs content standards for communications with the public concerning options. NASD Rule 2220(d)(1) provides, in pertinent part, that "[n]o member . . . or

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harmed by any delay in the filing of a complaint. *See Mark H. Love*, Exchange Act Rel. No. 49248, 2004 SEC LEXIS 318, at *16 (Feb. 13, 2004) ("We are unable to find, as a factual matter, that Love's ability to mount an adequate defense was harmed by any delay in the filing of a complaint against him.").

59 In November 2003, in the middle of the relevant period, Rule 2210(d)(1) was amended. There are three notable differences. Prior to November 2003: (1) Rule 2210(d)(1)(A) did not contain the requirement that member communications be "fair and balanced"; (2) Rule 2210(d)(1)(B) provided that "[e]xaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members"; and (3) Rule 2210(d)(1)(B) also provided that no member "shall, directly or indirectly," 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.

person associated with a member shall utilize any . . . communications to any customer or member of the public concerning options which: (A) contains any untrue statement or omission of a material fact or is otherwise false or misleading." Unlike NASD Rule 2210, NASD Rule 2220 contains no distinction between those who make communications and those who circulate or distribute them.

Murphy caused three types of communications to be sent to AL that violated such rules: profit and loss statements, a "change in account value" report, and a "safe options strategies" document. We address each below.

1. Profit and Loss Reports

Throughout the relevant period, Murphy caused 16 profit and loss reports to be created and sent to AL. Murphy testified that he did not create the profit and loss reports but that he "had them prepared" and that it was his idea to send them to AL. Each report purported to list each buy and sell options transaction that occurred within the periods covered by the report and any resulting realized profit and loss, both by series and in total. In an on-the-record interview, Murphy testified that the purpose of the profit and loss reports was to "[g]ive [AL] an idea of how we were doing" and that he sent similar reports to "all my clients."

The profit and loss reports contained false statements concerning the profits in AL's account. Twelve of those reports showed total profit figures that were overstated, with errors ranging as low as a few hundred dollars to as high as $38,503. Another report showed that AL earned a realized gain of $50,912.75 over a two-month period when, in fact, she incurred a realized loss of $40,489.85.[60] Such inaccuracies, which occurred in report after report and which concerned the profitability of AL's account, were material information. *Cf. Dep't of Enforcement v. Abbondante*, Complaint No. C10020090, 2005 NASD Discip. LEXIS 43, at *31-32 (NASD NAC Apr. 5, 2005) (holding that account statements are "critically important documents" and that creating false account statements "is the antithesis of a registered representative's [duty to uphold] high standards of commercial honor"), *aff'd*, Exchange Act Rel. No. 53066, 2006 SEC LEXIS 23 (Jan. 6, 2006), *petition for review denied*, 209 Fed. App'x 6 (2d Cir. 2006).

Murphy admitted that "[t]here was some shoddy work done" on the profit and loss statements and that, because he had directed that such reports be created, he shouldered the responsibility. Moreover, Murphy had reason to know that the profit and loss statements contained material inaccuracies. Although Murphy did not create the profit and loss statements himself, he checked them for accuracy. The errors in the profit and loss reports were not isolated, but were riddled throughout numerous reports over an extensive period of time. If Murphy did not notice that the profit and loss reports contained numerous inaccurate profit figures, it was only because he recklessly disregarded that fact.

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60 In addition to the incorrect profit totals, the profit and loss reports contained numerous errors on a line-by-line basis that contributed to the errors in the profit totals.

2. "Change in Account Value" Statement

Murphy also caused a single statement showing the "change in account value" for AL's margin account to be created and sent to AL.[61] Murphy testified that the document "was prepared for me" by someone else, and that it was Pesavento's idea to create it.[62] The statement purported to show, for each year between 2001 and 2005, the "starting value" of the account, the "ending value," and the "change in account value." The statement calculated such account value changes, however, in an inconsistent manner. For 2001 and 2002, the calculations accounted for changes in the equity values (both stock and options) and in any cash or margin debit balance. In contrast, for the years 2003 to 2005, the statement accounted only for changes in the equity values, but failed to account for any margin debit balance or cash in the account.

As a result, for the years 2003 to 2005 the statement contained numerous errors. It showed that the account value increased \$276,316 in 2003, when in fact it decreased \$7,738. It showed that the account decreased in value \$384,465 in 2004, when in fact it decreased \$1,136,736. For 2005, it showed that the account value had increased in value by \$256,031, when in fact it had increased by \$537,502.[63]

Murphy must have known that this document contained materially misleading information concerning the true status of AL's account. Two-thirds of the line item figures are incorrect, often by hundreds of thousands of dollars. The figure with which Murphy must have been most familiar when he sent the report—the most recent "ending value" figure—was overstated by \$700,000. Murphy testified that, although he reviewed the "change in account value" document at the time it was used, he could not say whether he had noticed any of the errors. If Murphy did not know that the change in account value document contained inaccuracies, however, it is only because he recklessly disregarded that fact.

3. "Safe Options Strategies" Document

Murphy also delivered to AL a document titled "Safe Option Strategies that can be employed." Murphy testified during his on-the-record interview that he asked an assistant to prepare this document. This document contained inaccuracies and an unbalanced presentation of the risks and rewards of various options strategies.

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61 Although there is no evidence when this statement, or the profit and loss reports, were sent to AL, there is no dispute that they were sent within the relevant period.

62 Pesavento testified to the contrary, stating that he did not ask for this change in account value statement and that it would not have helped him at all. It is not necessary to resolve this conflicting testimony.

63 The "change in account value" document was a communication "concerning" options, within the meaning of NASD Rule 2220(d)(1). In this regard, the document reported changes in the value of AL's account, in which the bulk of the trading that occurred involved options.

Among the purportedly "safe option strategies" described in this document was "buy[ing] a call option and sell[ing] a put option on the same underlying security," which the document stated "is a bullish strategy [that] seek[s] to profit from increasing prices." The document omitted, however, any discussion of the substantial risks involved with such a strategy. In a falling market, the call option might expire worthless and, because prices can fall to as low as zero, the short put option could generate substantial losses.

The document also included "short straddles" among the purportedly "safe option strategies." It explained that a short straddle is when "the option writer sells a call and a put on the same underlying security at the same strike price." It further explained that a short straddle strategy "is generally employed when the underlying security trades in a narrow range," which in turn "leaves the option writer with profit thanks to the premium he charged on both the short call and the short put." Although the potential upside was described, the document did not explain that the maximum loss that can be incurred with a short straddle is substantial if the stock price falls below the strike price on the put option—the price can fall as low as zero. And if the call is uncovered, the potential loss is unlimited as there is no limit on how high the price can rise.[64]

The inaccurate description of the options strategies as "safe," combined with the omissions of the substantial risks involved, rendered the "Safe Options Strategies" document materially misleading and unbalanced. Murphy must have known this, as such deficiencies are obvious to one experienced in options, even on just a cursory read.

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Respondents argue that the misleading communications described above did not violate NASD Rules 2210 or 2220 because they were not "sales literature" which, as defined in NASD Rule 2210(a)(2), is a category of communications that "is generally distributed or made generally available to customers or the public."[65] Although there is no evidence that the communications at issue were made available to anyone besides AL, the relevant rules were not limited to "sales literature," but were broad enough to cover all communications at issue. Specifically, NASD Rule 2210(d)(1) applies to "[a]ll member communications with the public," which includes "[c]orrespondence." In turn, "correspondence" included, prior to November 2003, "any written or electronic communication prepared for delivery to a single current or prospective customer" and, after November 2003, "any written letter . . . distributed by a member to . . . *one or more* of its existing retail customers." *See* NASD Rule 2210(a)(3) (2002); NASD Rules 2210(a)(3) (2006 NASD Manual), 2211(a)(1)(A) (2006 NASD Manual) (emphasis added). Likewise, NASD Rule 2220(d)(1) applies, in pertinent part, to "any . . . other communications to *any*

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64 *See* Chicago Board Options Exchange, *Weekly Strategy Discussion: The Short Straddle* (Nov. 24, 2009), http://www.cboe.com/Strategies/WeeklyStrategy.aspx?DIR= LCWeeklyStrat&File =112309%20-%20Short%20Straddle.doc&CreateDate=24.11.2009.

65 Prior to November 2003, Rule 2210(a)(2) defined "sales literature" to be a written or electronic communication that is "distributed or made generally available to customers or the public." NASD Rule 2210(a)(2) (2002). This slight difference is not material.

customer . . . concerning options" from a member or person associated with a member. (Emphasis added.) Thus, all of the misleading communications described above fell within the scope of NASD Rules 2210(d) and 2220(d)(1).

For the reasons explained above, Murphy utilized and distributed to a customer misleading communications concerning options, in violation of NASD Rules 2210, 2220, and 2110.

E. Supervision

The Hearing Panel found that Birkelbach failed to supervise Murphy's handling of AL's and BM's accounts, in violation of NASD Rules 3010, 2860(b)(20), and 2110. We affirm.

NASD Rule 3010(a) requires that a member "establish and maintain" a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [FINRA Rules]." "In addition to an adequate supervisory system, the duty of supervision includes the responsibility to investigate red flags that suggest that misconduct may be occurring and to act upon the results of such investigation." *Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *32-33 (Dec. 19, 2008) (internal quotation marks and brackets omitted). "Once indications of irregularity arise, supervisors must respond appropriately." *Id.* "The standard of 'reasonable' supervision is determined based on the particular circumstances of each case." *Id.*

NASD Rule 2860(b)(20) governs supervision of options accounts. That rule requires, in pertinent part, that a member implement a supervisory program that provides for the "diligent supervision" of options trading in customer accounts "by a general partner . . . or officer . . . of the member who is a Registered Options Principal . . . who has been specifically identified . . . as the member's Senior Registered Options Principal." NASD Rule 2860(b)(20)(A). The rule further provides, in pertinent part, that members implement procedures concerning supervising customer accounts that maintain "uncovered short option positions," including "frequent supervisory review of such accounts."

Birkelbach had supervisory responsibility of Murphy's options trading in AL's account and all of Murphy's trading in BM's account. As explained below, Birkelbach was aware of numerous red flags concerning Murphy's activities, failed to take appropriate supervisory action in response, and came nowhere close to the diligent supervision that was required to monitor the options trading in AL's account.

1. Supervision of AL's Account

As the Firm's SROP, Birkelbach was familiar with AL's account. He initially approved AL's account for covered options trading and purchases of options, and he later approved it for uncovered writing and spreading. Birkelbach knew that AL's P&G stock was essentially "her only asset" and that "she [did not] want to have her stock called away."[66] Birkelbach also was

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66 Birkelbach also testified that his understanding was that AL had "income needs, and . . . want[ed] about $10,000 a month out of the account, maybe more." Murphy gave the same

[Footnote continued on next page]

familiar with the trading that occurred in AL's account. He reviewed and approved all options trades, which constituted the large majority of the trading activity in AL's account. He reviewed options order tickets, confirmations, "option exception reports" that listed "accounts that have existing uncovered options positions," and "activity reports" from the clearing firm that showed the amount of trades and commissions. He also reviewed accounts to see if options trading was within "approved levels."

Given this, Birkelbach was aware, or should have been aware, of numerous red flags. Birkelbach should have noticed that Murphy's trading activity in AL's account was dramatically higher compared to when Jage managed it. Birkelbach should have been alarmed at the volume of trades, the amounts of commissions, and the growing margin debit balance. From the third quarter of 2002 through the end of 2005, options trading in AL's account accounted for 18% of BIS' total revenues. Indeed, Birkelbach admitted at the hearing that it was "obvious" when the commissions started to increase, and he admitted at an on-the-record interview knowing that Murphy was "trying to take advantage of some short-term moves." *Cf. Kettler*, 51 S.E.C. at 33 (finding that a red flag confronted the supervisor where an "account experienced a dramatic increase in transactions" and where the trading in a single account "produced a significant proportion of the firm's retail business"). And AL testified that she met with Birkelbach in July 2005 to discuss specifically the margin debit balance.

Birkelbach also must or should have been aware that Murphy was effecting individual options trades in AL's account that were highly risky and that exceeded the account's approved levels. For example, the parties stipulated that, from his review of the trading in AL's account, Birkelbach knew that, from August 2002 through October 2004, Murphy had effected uncovered options trades in AL's account. Likewise, Birkelbach should have noticed that Murphy was effecting other risky options transactions, including purchasing long calls and complex combinations. *Cf. Dep't of Enforcement v. VMR Capital Mkts. US*, Complaint No. C02020055, 2004 NASD Discip. LEXIS 18, at *28-29 (NASD NAC Dec. 2, 2004) (noting that numerous trades, in-and-out trading, and trading of highly speculative securities in conservative investors' accounts were "red flags"). In his on-the-record interview, Birkelbach conceded that he knew Murphy was effecting uncovered puts. Birkelbach also should have known that Murphy was

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testimony, but the Hearing Panel found that Murphy was not a credible witness and made no finding that AL sought $10,000 a month.

As noted above, the Hearing Panel implied that it did not find Birkelbach credible. But even if the Hearing Panel made no such determination, our independent assessment is that Birkelbach was not a credible witness. His hearing testimony sometimes conflicted with his previous sworn statements. For example, although he testified at the hearing that he thought that DeRose understood options, he stated the opposite view at an on-the-record interview. Similarly, although he hedged at the hearing that it "was a matter of opinion" whether an investor must be willing to speculate or engage in high risk trading to write uncovered calls, he conceded the point at an on-the-record interview.

engaging in trades that were too risky for AL, given his concession during an on-the-record interview that an investor's objectives should be "speculative or high risk" to trade uncovered options.

Birkelbach also knew that the Firm's chief compliance officer, Langlois, had various concerns about Murphy's trading. When Langlois had any such concerns, he would speak first with Murphy, and Langlois testified that he had such conversations with Murphy "frequently" and "[s]ometimes many times in a day." If speaking with Murphy did not resolve the matter to Langlois' satisfaction, he would raise the issue with Birkelbach. Langlois brought several of those concerns to Birkelbach's attention, including concerns about suitability, the losses in the account, and the lack of written discretionary authority, and Birkelbach testified that he had conversations with Langlois about AL's account "probably every day."

Birkelbach also knew that Langlois was troubled enough to send eight "activity letters" to AL from September 5, 2002, to April 1, 2005, about which Langlois conferred with Birkelbach before sending. Langlois testified that such letters were sent when there was "any concern over the activity." While the language varied, each letter noted the "high level of activity" or "active trading" in AL's account, and most specifically mentioned that the active trading included options trading. One of those letters, dated November 11, 2003, noted that AL had paid year-to-date commissions totaling $251,781, which by itself should have caused a high level of concern.

Birkelbach also was aware that Murphy's conduct had attracted the attention of regulators. Murphy testified that, prior to November 2004, a FINRA examiner alerted the Firm that there had been numerous uncovered options trades in AL's account. In November 2005, Birkelbach was aware that a FINRA employee had specifically asked him to place Murphy under heightened supervision. Likewise, Birkelbach knew that Murphy had a relevant disciplinary history. Specifically, in 1999, the SEC had sustained findings by the CBOE that Murphy had made discretionary trades in options and securities without advance written approval from his clients and his prior broker-dealer, and that he had made unauthorized trades of put warrants. The CBOE censured Murphy, barred him from associating with any exchange member organization for two months, and fined him $10,000. In addition, Birkelbach knew that Murphy had been the subject of arbitrations. Indeed, Murphy was the subject of numerous customer complaints, twelve prior to when he was assigned AL's account, and six during his management of AL's account.

In the face of these numerous red flags, the appropriate supervisory response required, among other things, an investigation into Murphy's trading of AL's account, the use of heightened supervision, and, where violations were detected, actions directed towards preventing future violations and possible disciplinary action by the Firm. *See Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *42 (July 6, 2005) (emphasizing "the need for heightened supervision when a firm chooses to have associated with it a person who has known regulatory problems or customer complaints"); *O'Neal*, 51 S.E.C. at 1133-34 (faulting supervisor for not performing an investigation "that included direct contacts with customers," where supervisor received numerous warnings and many customers' names continuously appeared in monthly activity reports). Had Birkelbach done so, he could have detected and halted the excessive trading early on.

Instead, Birkelbach took no meaningful action and allowed Murphy to churn AL's account for years. Birkelbach never disapproved of any options trade in AL's account. He never asked Murphy to explain how his frequent trading of AL's account was justified. He never checked phone records to see if Murphy and AL were having phone conversations, and never asked AL if Murphy had called her before every trade. Even when Birkelbach saw AL in BIS' offices, he never discussed with her the trading strategies being employed. And when Birkelbach approved AL's account for riskier options trading, he did so without contacting her to discuss it, relying only on Murphy's unverified assurances that AL had approved such a change. In response to Langlois' expressing a concern with the lack of written discretionary authority and the fact that the account had not been approved for discretionary trading, Birkelbach simply "assured" Langlois that it was "okay."[67] Birkelbach also conceded that he did little to verify the accuracy of the misleading profit and loss reports, testifying that he "looked" at such reports, but that "[t]hey were complicated," that "I didn't take the time to take my calculator and calculate everything that I saw," and that he was "not sure if anybody really looked at them . . . that well."

Respondents' numerous challenges to the findings of supervisory violations are unpersuasive. For example, respondents argue that Birkelbach "discussed [AL's] account frequently with Murphy." Even if he did, such discussions were not serious probes aimed to detect whether the trading was suitable, because Birkelbach purportedly found nothing about which to be concerned. Indeed, all that Birkelbach could offer about those discussions was that "the explanation[s] [Murphy] gave me seemed logical." Birkelbach conceded, however, that it was "kind of difficult now to recreate why these trades were made" and admitted that he did not even talk with Murphy about the options trading strategy he employed. Even a half-hearted probe, however, would have easily detected that Murphy's trading was unsuitable.

Birkelbach also believed that Murphy had talked to AL before he effected option trades in her account. But that belief was based on nothing more than Birkelbach's unverified assumption. Specifically, Birkelbach testified at an on-the-record interview that "every time I walked . . . into Mr. Murphy's office, he was talking to [AL]" and "I assumed that he was talking to [AL] about every trade." Birkelbach did not take any steps to verify his assumption, however, such as check phone records or contact the customer. Such inaction was not reasonable. *Cf. Michael H. Hume*, 52 S.E.C. 243, 248 (1995) (noting that where a supervisor is aware of "red flags or suggestions of irregularity," "the supervisor cannot discharge his or her supervisory obligations simply by relying on the unverified representations of employees") (internal quotation marks omitted).

In further defense, respondents argue that the Firm sent "activity letters" to AL, and that AL never contacted Langlois in response to those letters to discuss any concerns.[68] Those

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[67] In a troubling portion of his on-the-record interview, Birkelbach was evasive concerning whether he saw any circumstances in which a supervisor should directly ask a broker if he had exercised discretion without written authority.

[68] Each activity letter asked AL to confirm that such activity was "consistent with [her] investment objectives" and that she was "financially able to assume the risk associated with active trading."

activity letters, however, were not appropriate supervisory responses to the obvious problems. The letters did not even begin to offer AL, an unsophisticated investor, a real understanding of the trading activity. They failed to address the key problems—that excessive trading of speculative options coupled with excessive margin was substantially risky, that the options trading was generating significant trading losses, and that much of the options trading had not been authorized—and Birkelbach never contacted AL (nor ensured that Langlois contacted AL) to discuss what the activity letters meant.[69] Thus, Birkelbach could not interpret the fact that AL never contacted Langlois as a sign that there was no misconduct. *Cf. Quest Capital Strategies, Inc.*, 55 S.E.C. 362, 373 (2001) ("[S]upervisory personnel cannot rely solely upon complaints from customers to bring misconduct of employees to their attention, particularly where customers . . . may fail to realize that they have been mistreated.") (internal quotation omitted).

Respondents also contend that Birkelbach went "above and beyond" by "involving Ms. DeRose" and arranging for duplicate copies of account statements to be sent to her so that "another set of eyes" would be looking at the activity in AL's account. Respondents acknowledge, however, that it was AL who requested the duplicate account statements. Moreover, referring AL to DeRose was not a meaningful supervisory response. DeRose testified that she lacked experience with options trading, that Birkelbach had never asked her to review the options trading in AL's account or do anything with respect to AL's investments, that she was only "brought in to do a financial plan" that had nothing to do with respect to AL's investments, and that she reviewed the account statements only to learn AL's asset allocation and income.[70] Likewise, AL testified that Birkelbach had recommended she work with DeRose to "help me set up a trust for my children [and] . . . a will." Given DeRose's limited options knowledge and limited responsibilities, Birkelbach's referring DeRose to AL did little to ensure that Murphy's options trading violations would be detected and prevented.[71]

Respondents also argue that Birkelbach asked Murphy to hold "a number of face-to-face meetings and ma[ke] other contacts with [AL] and her advisors, DeRose and Pesavento, to discuss strategies and concerns." None of the respondents' citations show that any such meetings or contacts were Birkelbach's idea. In any event, respondents do not explain how

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69 Moreover, whatever good the activity letters might have done was easily nullified by Murphy, who minimized their import in conversations with AL. *Cf. Bucchieri*, 52 S.E.C. at 805 (rejecting argument that customers had "uncomplaining acceptance" of trades where customers did complain only to be told that there was nothing to worry about).

70 Birkelbach even conceded during his on-the-record interview that DeRose did not understand options "that well."

71 In a similar argument, respondents contend that the fact that DeRose and Pesavento did not express any concerns also excuses Birkelbach. As explained above, however, DeRose *did* express concerns about the trading activity and the commissions. Plus, there was no reason why Birkelbach should have expected them to express any concerns in the first place. In any event, Birkelbach could take little comfort in DeRose's or Pesavento's not raising additional concerns because Birkelbach was already aware of numerous red flags from other sources.

Birkelbach's simply telling Murphy to contact AL and her advisors would have in any way ensured that Birkelbach detected and prevented violations.[72]

Respondents also argue that, in 2007, Birkelbach placed Murphy on heightened supervision and hired independent consultants and that, in 2009, he employed a new options principal. Birkelbach did not take any of these steps, however, until after Murphy had churned AL's account for years, after FINRA began its investigation, and after the Illinois Department of Securities had imposed a temporary order of prohibition against Murphy, which was far too late. *Cf. Pellegrino*, 2008 SEC LEXIS 2843, at *53 (holding that "reasonable supervision required that [supervisor] correct the deficiencies promptly" and that supervisor's failure to take certain supervisory steps until after the commencement of an NASD investigation demonstrated unreasonable supervision).[73]

Respondents also try to blame Birkelbach's supervisory failures on Langlois. They argue that Langlois was familiar with Murphy's trading of AL's account and reviewed the transactions; that Birkelbach had confidence in and conferred with Langlois; and that Birkelbach "completely deferred" to Langlois' request to send activity letters. Birkelbach admitted, however, that he did not delegate the review of options trading to Langlois. Thus, the ultimate supervisory responsibilities over Murphy's options trading always remained with Birkelbach. *Cf. Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *29-30 (June 29, 2007) (emphasizing that the president of a brokerage firm is responsible for the firm's compliance with all applicable requirements unless and until he or she reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his or her duties).[74] Moreover, Birkelbach provided no evidence showing that he adequately monitored Langlois to ensure that he was carrying out any non-options related supervisory duties in an effective manner. Thus, none of respondents' arguments excuse Birkelbach's supervisory failures.

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[72] Birkelbach participated at one meeting with Murphy, AL, Pesavento, and DeRose in May 2005, but Pesavento testified that that meeting was "mostly social in nature."

[73] Moreover, all that Birkelbach said about the independent consultants he retained was that they would assist with the Firm's procedures manual and would "dot my I's and cross my T's." Birkelbach provided no details concerning how such consultants would help him detect and prevent the kind of violations in which Murphy engaged.

[74] Even if Birkelbach had delegated supervisory responsibility to Langlois concerning options trading—which he did not—such a delegation would have been unreasonable. Langlois was neither an options principal nor qualified to supervise Murphy's options trading. Indeed, at the hearing, Langlois testified that his personal experience trading options was almost non-existent. *See Kresge*, 2007 SEC LEXIS 1407, at *35 ("Members should determine that supervisors understand and can effectively conduct their requisite responsibilities.").

2. Supervision of BM's Account

Birkelbach had even more reason to be concerned with Murphy's handling of BM's account. Before Birkelbach assigned BM's account to Murphy, Birkelbach became aware that FINRA was investigating Murphy's trading of AL's account and, in May 2006, attended an on-the-record interview concerning that investigation. During that interview, Birkelbach admitted that he knew that Murphy may have placed trades without calling AL beforehand or without discussing the specifics of the trades to be effected. Thus, Birkelbach was already aware of Murphy's possible violations well before he transferred BM's account to Murphy in April 2007.

After BM's account was transferred, there were even more red flags concerning Murphy. Birkelbach testified that he reviewed the daily tickets and the "activity report" for BM's account. And in June 2007, Birkelbach spoke directly with BM, who complained about high commissions. Thus, Birkelbach should have seen that, right from the start, Murphy traded BM's account in a substantially more aggressive manner than Langlois had and that the commissions were exceedingly high for someone with BM's stated income and account value.

Respondents argue that the issues concerning Murphy's trading of BM's account lasted only three months and that, when the problems were detected, Birkelbach was "on top of it." The red flags concerning Murphy, however, were obvious before Birkelbach decided to transfer BM's account to Murphy. While it is not entirely clear what respondents mean by being "on top of it," we assume it relates at least to their claim that Birkelbach placed Murphy under heightened supervision in 2007. As noted above, however, Birkelbach did not implement any form of heightened supervision until after the Illinois Securities Department issued a temporary order of prohibition against Murphy on August 31, 2007, which was more than a month after BM closed his BIS account. Moreover, Birkelbach testified at an on-the-record interview that such heightened supervision did not involve any limitations on Murphy's non-supervisory activities. Even after that temporary order of prohibition had been issued, Birkelbach still had not asked BM if Murphy had talked with him prior to effecting trades. Whatever supervisory steps Birkelbach took concerning Murphy's handling of BM's account were not prompt enough.

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The need for Birkelbach to take appropriate supervisory actions could not have been more obvious. The circumstances called upon Birkelbach to investigate whether Murphy was engaging in churning, excessive trading, and suitability violations, and to employ appropriate measures to prevent any detected violations from occurring again. Instead, he overlooked warnings, relied on assumptions and representations from Murphy that he took no steps to verify, and did not interfere in any meaningful way. Had Birkelbach taken appropriate and prompt supervisory action, he could have detected and halted Murphy's churning and unsuitable trading of AL's account years earlier, and prevented the churning of BM's account before it even began. *Cf. Bradford John Titus*, 52 S.E.C. 1154, 1159-60 (1996) (holding that respondents failed to supervise by overlooking red flags of unsuitable options trading); *Kettler*, 51 S.E.C. at 33 (finding that respondent failed to supervise where he failed to respond to the dramatic increase in transactions which constituted a clear "red flag"). We therefore find that Birkelbach failed to supervise, in violation of NASD Rules 3010, 2860(b)(20), and 2110.

F. Confidentiality Provision

The Hearing Panel found that BIS used an improper confidentiality provision in a settlement agreement with AL, in violation of NASD Rule 2110. We affirm.

"[A]n integral aspect of the statutor[y] scheme for regulating broker-dealers and protecting investors is the responsibility of self-regulatory organizations . . . to investigate allegations that members and their associated persons have engaged in misconduct and to impose sanctions when appropriate." *Dep't of Enforcement v. Am. First Assocs. Corp.*, Complaint No. E1020040926-01, 2008 FINRA Discip. LEXIS 27, at *25 (FINRA NAC Aug. 15, 2008) (citing *William Edward Daniel*, 50 S.E.C. 332, 335 (1990)), *aff'd sub nom.*, *Joseph Ricupero*, Exchange Act Rel. No. 62891, 2010 SEC LEXIS 2988 (Sept. 10, 2010), *petition for review filed*, No. 10-4566 (2d Cir. Nov. 8, 2010). As explained in *NASD Notice to Members 04-44*, 2004 NASD LEXIS 49, at *1 (June 2004), "the use of certain provisions in settlement agreements with customers or other persons that impede, or have the potential to impede, NASD investigations and the prosecution of NASD enforcement actions violates NASD Rule 2110." In that notice, FINRA also highlighted several kinds of problematic provisions, including those "that require regulatory authorities to obtain a . . . subpoena, or pursue some other legal process, before the parties are permitted to disclose the terms of the settlement or the underlying facts of the dispute to the regulator." *Id.* at *4.

The Firm's settlement agreement with AL contained just such a restrictive confidentiality provision. Although the settlement agreement expressly stated that "[n]othing herein shall prohibit any party or its attorney from responding to any inquiry by any . . . securities industry self-regulatory organization ("SRO") such as NASD-Regulation," the following caveat was added:

> [AL] acknowledges that there is currently an investigation of [BIS, Birkelbach, and Murphy] by NASD-Regulation, Inc., and should this investigation evolve into a formal administrative disciplinary proceeding against one or more of the Respondent Parties, [AL] will only provide testimony or documents under subpoena, or other lawful process."

As FINRA explained concerning just such a provision, "[s]uch restrictive language is especially problematic for self-regulatory organizations (SROs), such as NASD, that do not have the legal authority to compel cooperation by customers or other persons not subject to the SROs' jurisdiction." *NASD Notice to Members 04-44*.

Respondents argue that the settlement agreement did not actually impede FINRA's investigation, but such an argument is inapposite for purposes of determining the Firm's liability. *See Am. First Assocs. Corp.*, 2008 FINRA Discip. LEXIS 27, at *27 n.27 (holding that FINRA's guidance governing confidentiality provisions "does not require proof that . . . confidentiality provisions actually impede a FINRA investigation in order to establish a Rule 2110 violation"). Accordingly, we find that BIS used an improper confidentiality provision in a settlement agreement in violation of NASD Rule 2110.

V. Sanctions

A. Murphy

1. Bar and Disgorgement

The Hearing Panel considered Murphy's exercising discretion without written authority, unauthorized trading, unsuitable trading, excessive trading, and churning violations as "part of the same course of conduct" and imposed a single sanction for those violations. The Hearing Panel barred Murphy and ordered that he pay $591,933.67 in disgorgement. We also impose a single sanction for these same violations, and we affirm the bar and the disgorgement order. We reduce the amount of the disgorgement order, however, to $585,174.67 to account for ill-gotten gains that Murphy no longer retains.[75]

The Guidelines recommend that, in egregious cases of churning, excessive trading, unsuitable recommendations, and unauthorized trading, we consider a suspension of up to two years or a bar and fines ranging from $2,500 (for suitability violations) or $5,000 (for churning, excessive trading, and unauthorized trading violations) to $75,000.[76] For exercising discretion without a customer's written authority, the Guidelines recommend that we consider imposing a fine between $2,500 and $10,000 and, in egregious cases, a suspension from 10 to 30 business days.[77] In deciding on an appropriate sanction, we consider the Guidelines' Principal Considerations in Determining Sanctions.

Murphy's violations were egregious, as demonstrated by numerous aggravating factors. Murphy's course of conduct lasted several years and involved numerous violative acts.[78] Murphy attempted to conceal his misconduct from AL.[79] In this regard, Murphy gave AL false assurances that her account was profitable, led her to believe falsely that his trading had been "safe" and had adhered to the covered call strategy she had requested,[80] failed to inform her that

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75 Murphy's use of misleading communications would have warranted substantial monetary and other sanctions towards the high end of the relevant range of sanctions in FINRA's Sanction Guidelines ("Guidelines"). *See FINRA Sanction Guidelines* 81-82 (2011 ed.) [hereinafter "*Guidelines*"], http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf. In light of the bar, however, we do not impose a separate sanction for Murphy's use of misleading communications.

76 *Guidelines*, at 79, 96, 100.

77 *Id.* at 87.

78 *Id.* at 6 (Principal Considerations in Determining Sanctions, Nos. 8, 9).

79 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 10).

80 For example, in a letter dated July 2, 2004 to AL, Murphy wrote that his trading strategy "[is] to generate safe income to offset increased living expenses" and that "the 'bottom-line' . . . is to continue with our covered-call strategy." Murphy's suggestion that he had effected a "safe"

[Footnote continued on next page]

her re-signing of account opening documents was approving her account for unsuitably risky options categories, and used misleading profit and loss summaries that routinely overestimated her profits.[81] Murphy also attempted to conceal his misconduct from his Firm, falsely telling Langlois that AL had authorized every trade. Murphy's violations generated $591,933.67 in commissions for himself[82] while causing trading losses totaling $871,301.95 in AL's account and $5,703.59 in BM's account.[83]

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strategy using only "covered calls" was incorrect not just as a general matter, but on the very date of the letter when AL held, in addition to covered calls, long calls and short puts.

81 We do not find that the "change in account value" statement, however, was evidence of his attempt to mislead.

82 During his management of AL's account, Murphy earned 60% of gross commissions from July 2002 through December 2003, and 58% from January 2004 through February 2006. As a result, he personally earned $588,804.12 in commissions by trading AL's account. Assuming his payout percentage remained at 58% when he traded BM's account, Murphy earned another $3,129.55 in commissions from trading BM's account.

83 *Id.* at 6, 7 (Principal Considerations in Determining Sanctions, Nos. 11, 17). Murphy argues that, with respect to the losses in AL's account, the extent of the harm should focus not solely on her options trading losses but on the losses she sustained in her entire portfolio. Under that rubric, between October 2001, when she opened her BIS account, and February 2006, AL's BIS account lost approximately $93,821, when accounting for options trading losses, the marked-to-market value of her P&G stock, dividends received, mutual fund distributions, commissions paid, and margin interest. We agree that the losses incurred in the entire account is one relevant consideration. Investing in options on equity securities that are already held is sometimes done precisely for how it affects the upside and downside potential of the entire portfolio. For example, a covered call generates additional income in exchange for limiting the potential upside of the underlying stock. However, the $871,301 in trading losses that are directly related to the options trading are also pertinent, and highly so. In this regard, it is significant that, had Murphy not engaged in any of the violative options trading, AL's account would be worth substantially more.

Murphy also argues that AL's account was "net positive" after accounting for her $150,000 settlement. Under the Guidelines, however, the possible import of any restitution is a separate consideration from the injury that results directly or indirectly from the violations. *Compare Guidelines* Principal Consideration No. 11 (whether the violation resulted directly or indirectly in injury and the nature and extent of such injury) with *Guidelines* Principal Consideration No. 4 (whether the respondent "voluntarily and reasonably attempted, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct"). *Id.* at 6.

The injured customers included unsophisticated investors.[84] Murphy has not accepted responsibility for his violations, but instead continues to blame others such as Pesavento, DeRose, and AL for his violations or for not preventing his violations.[85] It is further aggravating that, as explained above, Murphy has a relevant disciplinary history.[86]

Moreover, the record demonstrates that Murphy acted with intent.[87] Murphy's trading over a course of years was not just risky, but extremely so. In AL's account, he traded uncovered options and long calls, sometimes at levels that placed all of AL's account balance at risk, and allowed a margin debit balance to grow to extreme heights. In BM's account, Murphy engaged in in-and-out trading that generated stratospheric turnover and cost-to-equity ratios. He churned both accounts with scienter. And Murphy must have known that he lacked written authority to exercise discretion in either account and was making options trades that were neither authorized nor approved.[88]

We find no mitigating factors. The Guideline for exercising discretion without a customer's written authority provides that we should consider "[w]hether customer's grant of discretion was express or implied."[89] Although AL gave Murphy verbal authority to trade her account consistent with a covered call strategy and her desire for moderate risk, Murphy ignored those limitations and had neither express nor implied discretion for much of his trading. With respect to his trading of BM's account, Murphy argues that he "misunderstood" BM to have provided verbal authorization to "realign the portfolio along more conservative lines" and to "trade in the account." The record demonstrates, however, that BM did *not* give any such verbal authorization.

Respondents argue that, in Murphy's second phone call with BM, Murphy offered to refund a portion of the commissions. That offer, however, is not deserving of any mitigation. While a voluntary and reasonable attempt, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct can be mitigating, Murphy's offer was not reasonable.[90] At

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84 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 19).

85 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 2).

86 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 1).

87 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

88 Murphy testified that he was not aware at the time of any restrictions on the options activities in AL's account. Murphy had no reasonable basis, however, for any such belief. Indeed, he admitted he had reviewed the option agreement, which specifically indicated what levels of options trading were approved.

89 *Id.* at 87 (Principal Considerations in Determining Sanctions, No. 1).

90 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 4).

the same time Murphy made that offer, he was concealing from BM that he had continued to excessively trade the account and that the account value had plummeted.

To remedy Murphy's violations and protect the investing public, serious sanctions are needed. We bar Murphy in all capacities. We also affirm the Hearing Panel's decision to order Murphy to pay disgorgement. "[D]isgorgement is intended to force wrongdoers to give up the amount by which they were unjustly enriched." *Michael David Sweeney*, 50 S.E.C. 761, 768 (1991). Disgorgement is appropriate in all sales practice cases, even where an individual is barred, if, among other things, "the respondent has retained substantial ill-gotten gains."[91] Such is the case here.

The total commissions Murphy received as a result of his violations totaled $591,933.67. Murphy, however, did not retain this entire amount. Murphy was fined $5,000 by the Illinois Securities Department for engaging in "unethical practices" in connection with BM's account. Moreover, BM acknowledged in his settlement agreement that he had already received $1,759 in commission reimbursements, which the record suggests was paid by Murphy. Subtracting the $5,000 Illinois Securities Department fine and the $1,759 that BM acknowledged receiving in reimbursements from the commissions Murphy received from his violative trading, we find that Murphy retained ill-gotten gains of $585,174.67. We therefore order Murphy to pay disgorgement in that amount.

We decline to further reduce the disgorgement award based on any payments towards respondents' settlements with BM and AL for which Murphy may be responsible. Given that $585,174.67 is a reasonable approximation of Murphy's ill-gotten gains, it was respondents' burden to demonstrate why, and by how much, the disgorgement should be reduced as a result of the two settlements. Respondents failed to meet this burden. Although the record shows that all three respondents agreed to settle BM's claims for $3,000 (on top of previous commission reimbursements) and AL's claims for $150,000, respondents proffered no evidence concerning how much of those settlements was Murphy's responsibility.[92]

Respondents also argue that the "fine" should be more "reasonable" because the Illinois Securities Department has already sanctioned Murphy for his actions concerning BM's account. In determining sanctions, it is appropriate to consider whether another regulator has disciplined respondent for the same misconduct.[93] Here, the Illinois Securities Department found in a

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91 *Guidelines*, at 10 (Technical Matters).

92 At the appeal hearing, respondents' counsel asserted that Murphy was responsible for the "lion's share" of the $150,000 settlement with AL, but that is too vague to carry any evidentiary weight. Counsel also represented that he would file additional evidence concerning Murphy's share of the settlements, but he never did.

93 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 14); *cf. Management Financial, Inc.*, 46 S.E.C. 226, 235, 237 (1976) (reducing NASD's suspension based on the fact that respondent had "already been disciplined [by the SEC] for some of the violations involved in this appeal").

consent order that Murphy traded BM's securities without written authorization and for the purpose of generating commissions in violation of Section 8.E(1)(B) of the Illinois Securities Law of 1953, fined Murphy $5,000, required respondents to pay BM $3,000 for commission reimbursement, and prohibited Murphy from acting as a supervisor or taking on new clients for two months. Other than our deducting the $5,000 fine that Murphy paid to Illinois from the disgorgement award, however, we see no reason to further lower the fine (or the bar) in light of the Illinois consent order. That Murphy has served a limited state-wide ban for only a fraction of the misconduct before us does not demonstrate that Murphy does not pose a permanent threat to the investing public or that he retained less in ill-gotten gains than we have ordered be disgorged.[94]

2. <u>Pre- and Post-Judgment Interest</u>

Enforcement argues that we should also require Murphy to pay prejudgment interest on the disgorgement amount. In support, Enforcement cites two federal district court cases that awarded the SEC prejudgment interest on disgorgement orders. *See SEC v. Gunn*, Civ. Action No. 3:08-CV-1013-G, 2010 U.S. Dist. LEXIS 88164, at *7 (N.D. Tex. Aug. 25, 2010); *SEC v. Conaway*, 695 F. Supp. 2d 534, 538 (E.D. Mich. 2010). Nearly twenty years ago, however, our predecessor body rejected the awarding of prejudgment interest on disgorgement orders that are to be paid to FINRA:

> [T]he award of prejudgment interest is intended to compensate injured parties for the time value of the money that they lost as a result of wrongful conduct. Here, however, the rationale for assessing prejudgment interest is absent because the [District Business Conduct Committee ("DBCC")] ordered no customer restitution, and simply directed that a fine be paid to the NASD. The NASD, however, has no entitlement to the fine until a final decision is rendered in this case. Since this decision will not become final until some point in the future, we do not believe that it was appropriate for the DBCC to have assessed prejudgment interest . . . .

Dist. Business Conduct Comm. v. G.K. Scott & Co., Complaint No. NY-9026, 1992 NASD Discip. LEXIS 128, at *60-61 (NASD NBCC Apr. 30, 1992), *aff'd*, 51 S.E.C. 961 (1994), *petition for review denied*, 56 F.3d 1531 (D.C. Cir. 1995); *cf. Guidelines*, at 11 (discussing the awarding of interest only in the context of "ordering restitution"). We are aware of no decisions

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[94] In a related argument, respondents contend that to impose sanctions on Murphy for the conduct concerning BM's account for which the Illinois Securities Department has already imposed sanctions violates "fundamental fairness." The Exchange Act, however "provides several parallel and compatible procedures for the achievement of its objectives," and FINRA "has an independent statutory mandate to enforce the provisions of the Exchange Act, as well as its own rules." *Kirk A. Knapp*, 51 S.E.C. 115, 130-31 (1992) (rejecting argument that NASD was precluded from pursuing action against respondent that arose from the same misconduct that was already the subject of an SEC administrative action).

in which the NAC expressly overruled the policy announced in *G.K. Scott* or in which the SEC has directed FINRA to change that policy.[95]

We also reject Enforcement's argument that we award post-judgment interest on the disgorgement order. In FINRA disciplinary proceedings, when the disgorgement amount is to be paid to FINRA, the disgorgement award is essentially a fine. *See Guidelines*, at 5 (General Principles Applicable to All Sanction Determinations, No. 6) ("Adjudicators may require the disgorgement of . . . ill-gotten gain by fining away the amount of some or all the financial benefit derived"). Interest is not awarded on fines imposed through FINRA disciplinary proceedings.

3. <u>Inability to Pay</u>

Murphy also argues that he has an inability to pay the disgorgement order. In support of that argument, Murphy moved on appeal to introduce a Statement of Financial Condition. Although we have considered that evidence, we find that it is unreliable and, consequently, that Murphy has failed to demonstrate that he has an inability to pay.

In his Statement of Financial Condition, Murphy claims that he has a negative net worth of $141,083, and that his monthly expenses exceed his monthly income by $47,719. For some of the assertions contained therein, however, Murphy did not file adequate supporting documentation. For example, the statement required Murphy to submit his federal and state income tax returns filed during the last two years, but Murphy submitted only his 2009 income tax returns. The statement also required Murphy to submit his pay stubs for the last eight pay periods, but he submitted only a spreadsheet that purports to list payments made to him in 2010. The statement also required Murphy to submit documentation that supported any estimate of assets that exceeded $1,000, but he failed to provide any appraisals or supporting documentation in support of his assertion that his house was worth $380,000 as of December 1, 2010.[96]

Other assertions in Murphy's Statement of Financial Condition are highly questionable. For example, Murphy's claim that he has no bank accounts is unreliable, considering his other assertion that he receives substantial monthly income ($12,004) and evidence that shows he pays at least one of his credit card bills from a funding account. Murphy's claim that he owns just one

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95 In *Dep't of Enforcement v. Legacy Trading Co.*, Complaint No. 2005000879302, 2010 FINRA Discip. LEXIS 20, at *49 (FINRA NAC Oct. 8, 2010), the NAC awarded prejudgment interest on a disgorgement award that was to be paid to FINRA. Nothing in *Legacy*, however, expressly overruled the policy of not awarding prejudgment interest in such circumstances, nor is there any indication that the issue was actively litigated or that the existing FINRA policy had been brought to the NAC's attention. Thus, we do not read *Legacy* as expressly rejecting FINRA's policy of not awarding prejudgment interest on disgorgement amounts that are to be paid to FINRA.

96 Murphy's $380,000 estimate in his December 1, 2010 Statement of Financial Condition is even more questionable considering that, in his initial September 8, 2010 submission, he claimed his house was worth $410,000.

car (a 1982 Toyota that he values at $5,700) is dubious, considering his other assertions that he owes $10,049 on an auto loan and deducted $2,007 on his 2009 tax return for "new motor vehicle taxes." And Murphy's estimate that he has $59,723 in *monthly* expenditures is unreliable, considering that it includes figures that are, or strongly appear to be, *annual* expenditures (e.g., $25,508 in annual mortgage payments, $9,435 in real estate taxes, and $5,100 in utilities).

Because Murphy's Statement of Financial Condition is unreliable, we find that Murphy has failed to demonstrate that he has an inability to pay the disgorgement order.

B. Birkelbach

As explained below, the sanctions imposed by the Hearing Panel on Birkelbach are wholly insufficient to remedy his failure to supervise. We increase the sanction to a bar in all capacities.

"Assuring proper supervision is a critical component of broker-dealer operations." *Pellegrino*, 2008 SEC LEXIS 2843, at *33 (quotation omitted). The Guidelines provide that for failing to supervise, we consider imposing fines from $5,000 to $50,000, and a suspension in all supervisory capacities for up to 30 business days. In egregious cases, we are to consider imposing a suspension in any or all capacities for up to two years, or imposing a bar.[97]

There are numerous aggravating factors. As explained in detail above, Birkelbach ignored numerous and obvious red flag warnings that should have resulted in additional supervisory scrutiny, so much so that his supervisory failures must have stemmed from some degree of intent.[98] Birkelbach failed to prevent a years-long course of violative conduct that included churning, excessive trading, unsuitable recommendations, and trading without discretionary authority, and that led to significant customer harm.[99] Birkelbach also has not accepted responsibility, but instead has sought to shift blame to others, such as Langlois, who was not even an options principal, and AL's accountant and financial planner.[100] Such attempts to blame others for his misconduct demonstrate that Birkelbach fails to understand the seriousness of his violations. *Michael G. Keselica*, 52 S.E.C. 33, 37 (1994). Our discussion of his liability shows that Birkelbach's implementation of any supervisory efforts was abysmal.

It is further aggravating that Birkelbach has a relevant disciplinary history.[101] In 1999, he was the subject of a consent order issued by the Illinois Securities Department that was "based

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97 *Guidelines*, at 105.

98 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13), 105 (Principal Considerations in Determining Sanctions, No. 1).

99 *Id.* at 105 (Principal Considerations in Determining Sanctions, No. 2).

100 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 2).

101 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 1).

upon unauthorized trading, unsuitable transactions and excessive trading involving accounts of Illinois residents and churning customer accounts"—the very activity that he failed to detect and prevent here. For those violations, Birkelbach consented to a censure, a six-month suspension in Illinois, a requalification requirement, and a $50,000 restitution order (joint and several with BIS).

Respondents argue that any sanction imposed against Birkelbach should take into account the fact that respondents have settled with AL and BM. There is no evidence, however, concerning how much Birkelbach personally paid towards these monetary settlements. Moreover, any such payments would not amount to mitigating evidence that would warrant a reduction in the sanctions. Under the Guidelines, we consider whether a respondent "voluntarily and reasonably attempted, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct."[102] Birkelbach's settlements with AL and BM occurred only after FINRA had begun investigating the trading in AL's account and after BM had launched a formal complaint with FINRA.

Considering these facts and circumstances, we conclude that Birkelbach is a serious risk to the investing public, in whatever capacity he would function, that his failure to supervise was egregious, and that sanctions at the high end of the relevant range are warranted. Birkelbach's conduct reflects a shocking disregard for FINRA rules designed to protect customers. We impose on Birkelbach a bar in all capacities.[103]

C. BIS

The Hearing Panel imposed a $2,500 fine on BIS for its use of an improper confidentiality provision. We affirm.

For the use of improper confidentiality provisions, the Guidelines recommend that we impose a fine between $2,500 and $50,000 and suspend the firm with respect to any or all

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102 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 4).

103 Citing *U.S. v. Shue*, 825 F.2d 1111, 1115-16 (7th Cir. 1987), respondents argue that Enforcement's request that the sanctions on Murphy and Birkelbach be increased reflects an attempt "to penalize Respondents for exercising their right to appeal" and that "[t]his constitutes an unconstitutional exercise of [Enforcement's] power" and fails to provide "fundamental fairness." As an initial matter, "FINRA is not a state actor and is therefore not bound by constitutional limitations applicable to government agencies." *Timothy P. Pedregon, Jr.*, Exchange Act Rel. No. 61791, 2010 SEC LEXIS 1164, at *23-24 (Mar. 26, 2010). Moreover, the due process protection addressed in *Shue* concerns restrictions on "imposing a greater sentence on a defendant after a successful appeal of a conviction and retrial." *Shue*, 825 F.2d at 1116. That is not the procedural posture here. There is also nothing untoward about Enforcement's request for increased sanctions. NASD Rule 9349(a) expressly authorizes the NAC to increase any sanction.

activities or functions for one month to two years. In egregious cases, the Guidelines recommend that we consider expelling the firm.[104]

There are several mitigating factors. Although the confidentiality provision had the potential to impede FINRA's enforcement efforts, the settlement agreement did not prohibit AL from all forms of cooperation with regulators, and it expressly permitted AL to respond to FINRA inquiries.[105] Moreover, when FINRA alerted BIS' attorney of the improper confidentiality provision, he informed AL that such provision should not be construed to prohibit or restrict her from responding to FINRA about the settlement or its underlying facts and circumstances.[106] In the end, Enforcement was able to gain AL's substantial cooperation, including her testimony. For these reasons, we think sanctioning BIS at the low end of the applicable range is sufficiently remedial. *Cf. Am. First Assocs. Corp.*, 2008 FINRA Discip. LEXIS 27, at *33 (finding it mitigating that respondents promptly attempted to release the customer from the settlement's non-disclosure provisions when informed by FINRA of the deficiency and that the settlement agreement did not preclude FINRA from speaking with the customer). We affirm the $2,500 fine imposed on BIS.

VI. Conclusion

Accordingly, we affirm the Hearing Panel's findings that: (1) Murphy engaged in discretionary trading without written authorization from his clients or Firm, excessive trading and churning, unsuitable trading, unauthorized trading, trading beyond approved levels, and causing the creation and distribution of inaccurate, unbalanced, and misleading communications; (2) Birkelbach failed to supervise Murphy; and (3) BIS used an improper confidentiality provision in a settlement agreement with a customer.

For Murphy's collective violations (excluding his use of misleading communications), we bar Murphy and fine him $585,174.67, an amount that represents disgorgement. We bar Birkelbach in all capacities. We affirm the $2,500 fine on BIS. Finally, we affirm the order that respondents pay $9,503.17 in hearing costs (joint and several), and we order that respondents pay

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104 *Id.* at 32.

105 *Id.* at 32 (Principal Considerations in Determining Sanctions, No. 1).

106 *Id.* at 32 (Principal Considerations in Determining Sanctions, No. 3).

$3,510.80 in appeal costs (joint and several). The bars imposed on Murphy and Birkelbach are effective immediately upon issuance of this decision.[107]

On Behalf of the National Adjudicatory Council,

Marcia E Asquith

Marcia E. Asquith,
Senior Vice President and Corporate Secretary

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[107] We also have considered and reject without discussion all other arguments advanced by respondents.

Pursuant to FINRA Rule 8320, any member that fails to pay any fine, costs, or other monetary sanctions imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be revoked for non-payment.

FINRA
Financial Industry Regulatory Authority

Michael J. Garawski
Associate General Counsel
Direct: (202) 728-8835
Fax: (202) 728-8264

October 20, 2011

VIA MESSENGER

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Complaint No. 2005003610701: William J. Murphy, Carl M. Birkelbach, and Birkelbach Investment Securities, Inc.

Dear Ms. Murphy:

Enclosed please find the decision of the National Adjudicatory Council ("NAC") in the above-referenced matter. The FINRA Board of Governors did not call this matter for review, and the attached NAC decision is the final decision of FINRA.

Very truly yours,

Michael J. Garawski

Enclosure

FINRA®
Financial Industry Regulatory Authority

Michael J. Garawski Direct: (202) 728-8835]
Associate General Counsel Fax: (202) 728-8264

October 20, 2011

VIA CERTIFIED AND FIRST-CLASS MAIL

Christopher Wurtzinger
Chief Compliance Officer
Birkelbach Investment Securities, Inc.
208 South La Salle #1442
Chicago, IL 60604-1103

RE: Complaint No. 2005003610701: William J. Murphy, Carl M. Birkelbach, and Birkelbach Investment Securities, Inc.

Dear Sir:

Rule 9349(c) of the FINRA Code of Procedure specifies that current employers be notified and provided a copy of National Adjudicatory Council decisions involving their employees. This is to advise you that FINRA named William J. Murphy and Carl M. Birkelbach as respondents in the National Adjudicatory Council decision referenced above. A photocopy of the National Adjudicatory Council's October 20, 2011 decision is enclosed.

If you have any questions, you may contact Deb Baker, Legal Assistant, at (202) 728-8852.

Very truly yours,

Michael J. Garawski

Enclosure

cc: William J. Murphy
Carl M. Birkelbach
James J. Moylan, Esq.
Kendra Thramann Marderosian, Esq.

FINRA

Financial Industry Regulatory Authority

Marcia E. Asquith
Senior Vice President and
Corporate Secretary

Direct: (202) 728-8831
Fax: (202) 728-8300

October 20, 2011

VIA CERTIFIED MAIL:
RETURN RECEIPT REQUESTED/FIRST-CLASS MAIL

James J. Moylan, Esq.
James J. Moylan and Associates, P.C.
Tree Haus
31685 Inca Way
P.O. Box 775965
Steamboat Springs, CO 80477-5965

Kendra Thramann Marderosian, Esq.
644 S. Grove Ave.
Barrington, IL 60010

Re: Complaint No. 2005003610701: William J. Murphy, Carl M. Birkelbach, and Birkelbach Investment Securities, Inc.

Dear Counsel:

Enclosed is the decision of the National Adjudicatory Council ("NAC") in the above-referenced matter. The Board of Governors of the Financial Industry Regulatory Authority ("FINRA") did not call this matter for review, and the attached NAC decision is the final decision of FINRA.

In the enclosed decision, the NAC imposed the following sanctions: The NAC barred William J. Murphy in all capacities and imposed a fine of $585,174.67, an amount that represents disgorgement. The NAC barred Carl M. Birkelbach in all capacities. The NAC fined Birkelbach Investment Securities, Inc. $2,500. The NAC also affirmed the order that all three respondents pay $9,503.17 in hearing costs (joint and several), and ordered that all three respondents pay $3,510.80 in appeal costs (joint and several).

Please note that under Rule 8311 ("Effect of a Suspension, Revocation or Bar"), because the NAC has imposed bars, effective immediately Mr. Murphy and Mr. Birkelbach are not permitted to associate further with any FINRA member firm in any capacity, including a clerical or ministerial capacity.

Pursuant to Article V, Section 2 of the FINRA By-Laws, if your clients are currently employed with a member of FINRA, they are required immediately to update their Forms U4 to reflect this action.

Your clients are also reminded that the failure to keep FINRA apprised of their most recent address may result in the entry of a default decision against them. Article V, Section 2 of the FINRA By-Laws requires all persons who apply for registration with FINRA to submit a Form U4 and to keep all information on the Form U4 current and accurate. Accordingly, your clients must keep their member firm informed of their current address.

In addition, FINRA may request information from, or file a formal disciplinary action against, persons who are no longer registered with a FINRA member for at least two years after their termination from association with a member. See Article V, Sections 3 and 4 of FINRA's By-Laws. Requests for information and disciplinary complaints issued by FINRA during this two-year period will be mailed to such persons at their last known address as reflected in FINRA's records. Such individuals are deemed to have received correspondence sent to the last known address, whether or not the individuals have actually received them. Thus, individuals who are no longer associated with a FINRA member firm and who have failed to update their addresses during the two years after they end their association are subject to the entry of default decisions against them. See Notice to Members 97-31. Letters notifying FINRA of such address changes should be sent to:

CRD
P.O. Box 9495
Gaithersburg, MD 20898-9401

Your client (or clients) may appeal this decision to the U.S. Securities and Exchange Commission ("SEC"). To do so, an application with the SEC must be filed within 30 days of your receipt of this decision. A copy of this application must be sent to the FINRA Office of General Counsel, as must copies of all documents filed with the SEC. Any documents provided to the SEC via facsimile or overnight mail should also be provided to FINRA by similar means.

The address of the SEC is:

The Office of the Secretary
Securities and Exchange
Commission
100 F Street, N.E.
Mail Stop 1090 – Room 10915
Washington, D.C. 20549

The address of FINRA is:

Attn: Michael J. Garawski
Office of General Counsel
FINRA
1735 K Street, N.W.
Washington, D.C. 20006

If any of your clients files an application for review with the SEC, the application must identify the FINRA case number and state the basis for the appeal. Your client must include an address where he may be served and a phone number where he may be reached during business hours. If his address or phone number changes, he must advise the SEC and FINRA. Attorneys must file a notice of appearance.

The filing with the SEC of an application for review shall stay the effectiveness of any sanction except a bar or expulsion. Thus, the bars imposed by the NAC in the enclosed decision will not be stayed pending appeal to the SEC, unless the SEC orders a stay. Additionally, orders in the enclosed NAC decision to pay fines and costs will be stayed pending appeal.

Questions regarding the appeal process may be directed to the Office of the Secretary at the SEC. The phone number of that office is (202) 551-5400.

If your clients do not appeal this NAC decision to the SEC and the decision orders your clients to pay fines or costs, your clients may pay these amounts after the 30-day period for appeal to the SEC has passed. Any fines and costs assessed should be paid (via regular mail) to FINRA, P.O. Box 7777-W8820, Philadelphia, PA 19175-8820 or (via overnight delivery) to FINRA, W8820-c/o Mellon Bank, Room 3490, 701 Market Street, Philadelphia, PA 19106.

Very truly yours,

Marcia E Asquith

Marcia E. Asquith
Senior Vice President and Corporate Secretary

cc: Carl M. Birkelbach
William J. Murphy
Birkelbach Investment Securities, Inc.
Leo F. Orenstein, Esq.
Marcletta Kerr, Esq.
Dale Glanzman, Esq.