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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RESPONDENT 1, RESPONDENT 2, and RESPONDENT 3 Respondents.	Disciplinary Proceeding No. 2012031496501 Hearing Officer–MJD

ORDER DENYING RESPONDENTS'
MOTION FOR PARTIAL SUMMARY DISPOSITION

I. Background

On July 28, 2015, the Department of Enforcement filed a six-cause Complaint against three Respondents. On February 5, 2016, two Respondents, Respondent 1 and Respondent 2 (together "Movants"), filed a motion for partial summary disposition as to the charges set forth in five of the six causes of action.[1] On February 26, 2016, Enforcement filed its Opposition.

Respondent 2 is Respondent 1's President and Chief Compliance Officer and Respondent 3's designated supervisor. Respondent 3 is no longer associated with the Respondent 1. The central charge of the Complaint (set out in causes one through three) is that Respondent 3 fraudulently churned the accounts of six customers and made unsuitable quantitative and qualitative recommendations to them. Enforcement alleges that Respondent 1 is liable for Respondent 3's fraudulent actions and unsuitable recommendations under the doctrine of *respondeat superior*.[2] For the misconduct described in causes one through three, Enforcement alleges that Respondent 3 and Respondent 1 violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5, NASD Rules 2310, IM-2310-2, 2120, and 2110, and FINRA Rules

[1] Cause five alleges that Respondent 3 did not timely disclose three federal tax liens on his Form U4, in violation of Article V, Section 2(c) of FINRA's By-Laws and FINRA Rules 1122 and 2010. Because it charges only Respondent 3 with misconduct, cause five is not a subject of Respondent 1 and Respondent 2's motion for partial summary disposition.

[2] Complaint ("Compl."), ¶¶ 102, 108, 115.

2020 and 2010. The Complaint estimates that Respondent 3's excessive trading and churning caused the six customers to lose more than $800,000.

Causes four and six allege that Respondent 1 and Respondent 2 failed to reasonably supervise Respondent 3 in the face of numerous red flags evidencing that he made unsuitable recommendations, was engaged in excessive and fraudulent trading of customer accounts, and failed to update his Form U4 to disclose federal tax liens totaling more than $700,000.

II. Discussion

A. Summary Disposition Standards

FINRA Rule 9264 permits a party to file a motion for summary disposition and sets forth the procedures for making and deciding such a motion. Subsection (d) expressly provides that any motion for summary disposition "shall be accompanied" by "a statement of undisputed facts," a supporting memorandum, and "affidavits or declarations that set forth such facts as would be admissible at the hearing and show affirmatively that the affiant is competent to testify to the matters stated therein."

FINRA Rule 9264 also sets forth the standard for granting a motion for summary disposition. Under subsection (e), summary disposition is permitted "if there is no genuine issue with regard to any material fact and the Party that files the motion is entitled to summary disposition as a matter of law." Subsection (e) further provides "the facts alleged in the pleadings of the Party against whom the motion is made shall be taken as true" (except as modified by stipulation of uncontested affidavits or other means, none of which are relevant here).

It is well-established that a motion for summary disposition under FINRA Rule 9264 is analyzed in the same general way as a motion for summary judgment under Rule 56 of the Federal Rules of Civil Procedure.[3] Under Rule 56, the evidence of the non-moving party will be believed as true, all doubts will be resolved against the moving party, all evidence will be construed in the light most favorable to the non-moving party, and all reasonable inferences will be drawn in favor of the party opposing the motion.[4] "Summary disposition is properly granted when no genuine and disputed issues of material fact remain, and when, viewing the evidence most favorably to the non-moving party, the movant is clearly entitled to prevail as a matter of law. All reasonable inferences must be drawn in favor of the party opposing summary disposition."[5] Summary judgment cannot be granted if there is disagreement over the inferences that could reasonably be drawn from those facts.[6] Even when a summary judgment motion is not

[3] *See* OHO Order 07-37 (2005001919501) at 10, http://www.finra.org/sites/default/files/OHODecision/p037809.pdf.

[4] *See, e.g., Tolan v. Cotton*, 134 S. Ct. 1861, 1863, 1866 (2014); *Crawford v. Metropolitan Gov't of Nashville & Davidson County*, 555 U.S. 271, 274 n.1 (2009); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23 (1986); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587-88 (1986) (citing *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962)).

[5] *See* OHO Order 07-37 (2005001919501) at 10.

[6] *See Ideal Dairy Farms, Inc. v. John Labatt, Ltd.*, 90 F.3d 737, 744 (3d Cir. 1996).

contested, and thus no dispute of material fact is demonstrated, summary judgment may only be awarded where the moving party should prevail as a matter of law.[7]

Accordingly, it is the movant's responsibility to inform the adjudicator "of the basis for its motion" and to identify "those portions of 'the pleadings, depositions, . . . and admissions on file, together with the affidavits, if any,' which it believes demonstrates the absence of a genuine issue of material fact."[8] Once the movant has done so, the non-moving party must "come forward with 'specific facts showing that there exists a *genuine issue*' for hearing."[9]

Further, when ruling on a summary disposition motion, the adjudicator should not "weigh the evidence and determine the truth of the matter."[10] Rather, the adjudicator must "instead determine whether the evidence presents a disagreement sufficient to require submission to fact finding."[11] Finally, "[w]hen the record as a whole could not lead a rational adjudicator to find for the nonmoving party, no genuine issues exist that warrant a hearing."[12] But if "the nonmoving party produces sufficient evidence to raise a question as to the outcome of the case, then the motion for summary disposition should be denied."[13]

Applying the above principles makes the grant of summary disposition inappropriate here. Based on a review of the parties' submissions, the Hearing Officer finds that Movants have failed to show that there are no genuine disputes of material fact.

B. Respondent 1 and Respondent 2 Fail to Show that Summary Disposition is Warranted

Respondent 1 and Respondent 2's motion is procedurally defective and lacks merit.

1. The Motion is Not Accompanied by Any Affidavit or Declaration

FINRA Rule 9264 requires that a motion for summary judgment be accompanied by one or more affidavits or declarations setting forth such facts as would be admissible at the hearing. Respondent 1 and Respondent 2 also attached four exhibits, which include copies of five email exchanges with just two of the six customers having little discernable to do with the thousands of securities transactions at issue. One of the exhibits is a list of phone calls, containing dates and

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[7] *See Edwards v. Aguillard*, 482 U.S. 578, 595 (1987); *Torres-Rosado v. Rotger-Sabat*, 335 F.3d 1, 9 (1st Cir. 2003).

[8] *Dep't of Enforcement v. Respondent*, No. C02050006, 2007 NASD Discip. LEXIS 13, *12 (NAC Feb. 12, 2007), citing *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986) (quoting FED.R.CIV.P. 56(c)).

[9] *Id.*, citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp*., 475 U.S. 574, 587 (1986) (quoting FED.R.CIV.P. 56(e)) [emphasis in original].

[10] *Id.*, at *13, citing *Anderson v. Liberty Lobby, Inc*., 477 U.S. 242, 249 (1986).

[11] *Id.* citing *Anderson*, 477 U.S. at 251–52.

[12] *Id.* citing *Matsushita*, 475 U.S. at 587.

[13] *Id.* citing *Anderson*, 477 U.S. at 248.

phone numbers, purporting to have taken place between Respondent 3 and his customers.[14] Aside from questions concerning their relevance, the exhibits are not supported by an affidavit, as required by the rule.

2. The Statement of Undisputed Facts Fails to Address Any Material Facts Raised in the Motion Itself

Movants' statement of undisputed facts, which comprises 22 numbered paragraphs, recites allegations in the Complaint that primarily provide only general background facts about each of the Respondents and Respondent 3's customers and barely touches on the charges contained in the five counts that Respondent 1 and Respondent 2 are alleged to have violated. It fails altogether to set forth undisputed material facts relating to the elements of the causes of action alleged in the Complaint.[15] The result is that Movants have failed to provide material evidence to support their motion.

Movants' procedural deficiencies alone warrant denial of their motion.[16]

3. There are Genuine Issues of Material Fact as to All Five Causes

The procedural failures result in a substantive deficiency. Even ignoring the procedural shortcomings in the motion, Movants have failed to establish that there are no material facts in dispute.

a. Causes One and Two – Excessive Trading and Churning

Cause one of the Complaint alleges that Respondent 1 and Respondent 3 excessively traded six customers' accounts, in violation of NASD Rules 2310, IM-2310-2, and 2110 and FINRA Rule 2010. To prove excessive trading, or quantitative suitability, requires satisfying two elements: (i) a broker's "control over the account," and (ii) "excessive trading activity inconsistent with the customer's financial circumstances and investment objectives."[17] A broker has control over an account if he "has either discretionary authority or *de facto* control over the account."[18]

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[14] See Motion for Partial Summary Disposition, at Ex. B.

[15] Enforcement did not submit its own Statement of Undisputed Material Facts because it agrees with all of the facts set forth in Movants' Statement. Enforcement's Opposition to Motion for Partial Summary Disposition, at 3-4.

[16] See OHO Order 08-11 (E3A20030495-01), http://www.finra.org/sites/default/files/OHODecision/p039046_0.pdf (denying motion where movant failed to submit statement of undisputed facts and thus provided no evidence to support factual assertions); OHO Order 06-48 (200500127502), http://www.finra.org/sites/default/files/OHODecision/p018456.pdf (denying motion that failed to meet requirements of Rule 9264).

[17] *Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *34 (NAC July 30, 2009).

[18] *Id*.

Cause two alleges that Respondent 1 and Respondent 3's trading was so excessive that it amounted to churning, which involves fraudulent intent. To prove churning, a third element – scienter – is required.[19] Scienter requires proof of an intent to deceive, manipulate, or defraud,[20] or "severe recklessness involving an extreme departure from the standards of ordinary care."[21] The Complaint alleges that Respondent 3 engaged in thousands of transactions, resulting in annualized cost-to-equity ratios as high as 182 percent.[22] By churning the customers' accounts, Enforcement alleges that Respondent 1 and Respondent 3 violated Section 10(b) of the Exchange Act, Rule 10b-5, NASD Rules 2120 and 2110, and FINRA Rule 2020 and 2010.

Movants do not address whether Respondent 3's trading was excessive. Instead they assert that the firm is not liable for the excessive trading and churning violations alleged because Respondent 3 did not have discretionary authority or *de facto* control over his customers' accounts. According to Movants' unverified assertions, "there is no dispute" that Respondent 3 was not granted discretionary authority and did not have *de facto* control over his clients' accounts "because the clients were financially sophisticated, such that they could determine their own best interest, and with this sophistication and knowledge continually acquiesced to Respondent 3's advice."[23] Movants assert that each of the customers was financially sophisticated, based on their "age, education, business experience, frequency of communications with [Respondent 3], and . . . investment experience and knowledge."[24]

Enforcement opposes the motion on the grounds that the issue of Respondent 1 and Respondent 3's control of the customer accounts is a factual issue that must be resolved before addressing whether Movants should prevail. That question cannot be decided based on the current record. Movants have presented no evidence for their factual assertions, and the allegations of the Complaint, which must be taken as true, contradict claims that Respondent 1 and Respondent 3 did not otherwise control the customers' account.[25] Contrary to Movants' unverified statements about the customers, the Complaint alleges that none of them were sophisticated investors and that their investment experience was limited to mutual funds.[26] It also alleges that Respondent 3 populated customer account forms exaggerating their experience, financial condition, and investment objectives. He also falsely described their investment objective and risk exposure as "Speculation," according to the Complaint.[27] The Complaint

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[19] *Id*., at 34-35.

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

[21] *See Dep't of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17, at *44-45 & n.27 (NAC June 25, 2001) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991).

[22] Compl. ¶ 38.

[23] Motion for Partial Summary Disposition, at 5.

[24] Motion for Partial Summary Disposition, at 5.

[25] Compl. ¶¶ 26, 36, 48, 69.

[26] Compl. ¶ 18.

[27] Compl. ¶¶ 18, 23, 33, 44-45, 65-66.

further alleges that Respondent 3 made all investment decisions for the customers and "seldom advised them" of transactions.[28] These allegations undercut the basis for Movants' unverified claims that the customers were sophisticated and understood what Respondent 3 was doing.

b. Cause Three – Unsuitable Recommendations

Cause three alleges that, after the six customers had suffered losses from the churning activity, the firm and Respondent 3 made unsuitable qualitative recommendations that they invest their remaining funds in a single risky, low-priced security – Sirius XM Radio, Inc. (SIRI).[29] As a result of Respondent 1 and Respondent 3's recommendations, the customers concentrated between 60 percent and 98 percent of the funds remaining in their accounts in SIRI, according to the Complaint.

The suitability rule requires that a broker have a reasonable belief that recommended transactions are suitable for a customer, based on information obtained from the customer and a reasonable inquiry into the customer's investment objectives, financial situation, and needs.[30] A broker's recommendations must also be consistent with the customer's best interests[31] and adhere to the fundamental responsibility of fair dealing with customers.[32] A broker must "tailor his recommendations to the customer's financial profile and investment objectives."[33] A recommendation violates the suitability rule if a broker inadequately assesses whether the recommendation is suitable for a specific customer.[34] The Complaint alleges that Respondent 3 lacked reasonable grounds for believing that his customers "were willing and able to assume the risk particular to having their accounts heavily concentrated in one security."[35]

Movants fail altogether to address the suitability of Respondent 3's recommendation that customers invest a high concentration of their account funds in SIRI. Instead, they make unverified assertions that the investment strategy was implemented "after years of frequent communications" between Respondent 3 and the customers, and "was consisted with the clients'

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[28] Compl. ¶ 99.

[29] Compl. ¶¶ 17, 37, 58, 73, 77, 81, 110-16. Cause three alleges that Respondent 1 and Respondent 3 violated NASD Rules 2310 and 2110 and FINRA Rule 2010. Compl. ¶ 116.

[30] *Rafael Pinchas*, 54 S.E.C. 331, 340-41 (1999).

[31] *See Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (citing *Raghavan Sathianathan*, Exchange Act Release No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006)); *Dep't of Enforcement v. Dunbar*, No. C07050050, 2008 FINRA Discip. LEXIS 18, at *20 (NAC May 20, 2008).

[32] *Epstein*, 2009 SEC LEXIS 217, at *38-39.

[33] *Id.* at *43 (quoting *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168 (1989)).

[34] *Michael Frederick Siegel*, Exchange Act Release No. 58737, 2008 SEC LEXIS 2459, at *28-29 & n.23 (Oct. 6, 2008) ("The suitability rule thus requires that, before making a customer-specific suitability determination, a registered representative must first have an 'adequate and reasonable basis' for believing that the recommendation could be suitable for at least some customers.") (citing *Terry Wayne White*, 50 S.E.C. 211, 212 n.4 (1990), *aff'd as to liability and sanctions, remanded as to restitution*, 592 F.3d 147 (D.C. Cir. 2010)).

[35] Compl. ¶ 113.

investment objectives and needs."[36] They further assert that "there is no dispute" that Respondent 2 reasonably believed that the strategy was implemented "pursuant to the representations and approval" of the customers. From this conclusory statement, Movants make the leap that they "believed [the strategy] was qualitatively suitable."[37]

The facts set forth in the Complaint support the inference that Respondent 3's recommendations that customers' concentrate an unreasonably high percentage of their account assets in SIRI were unsuitable. Thus the suitability of SIRI for Respondent 1 and Respondent 3's customers is in dispute. Movants have not met the standard for summary disposition as to cause three.

c. Causes Four and Six – Supervision

Causes four and six allege supervisory deficiencies by Respondent 1 and Respondent 2 that constituted violations of NASD Rules 3010(a) and (b) and 2010 and FINRA Rule 2010. Enforcement alleges that the firm, acting through Respondent 2, failed to establish and maintain a supervisory system and written supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and rules. More specifically, the Complaint alleges that Respondents failed to investigate and act on multiple red flags that Respondent 3 was churning and making unsuitable recommendations to his customers, and that they maintained an inadequate supervisory system and written procedures to ensure the timely filing of updates to a Form U4.[38]

Respondent 1 and Respondent 2 assert that "it is undisputed" the customers were "in constant contact" with Respondent 3 and "periodically with" Respondent 2, during which "they consistently represented that they had . . . the sophistication to knowingly acquiesce to the trading strategy and commissions charged." In support of this claim, they cite to a single 2012 email from one of the customers asking if the firm was accepting new customers.[39] Movants also state that "it is undisputed" that they "were reasonably under the impression that no affirmative action to intervene in the investment strategy was needed, and as such, did not."[40] They assert that because of the alleged communications with customers and because the customers did not complain to them, Respondent 1 and Respondent 2 "did not fail to supervise Respondent 3."[41]

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[36] Motion for Partial Summary Disposition, at 14. To support claims of frequent communications with customers, Movants attach as Ex. B a list of telephone calls made between Respondent 3 and the six customers. Enforcement argues that it is conjecture, and there is no support, to assume that the calls involved Respondent 3 soliciting trades or telling customers of trading activity. Furthermore, Movants made no effort to match trading activity with phone calls. Enforcement's Opposition to Motion for Partial Summary Disposition, at 8.

[37] Motion for Partial Summary Disposition, at 15.

[38] Compl. ¶¶ 117-23, 132-42.

[39] Motion for Partial Summary Disposition, at 15; Ex. D.

[40] Motion for Partial Summary Disposition, at 15.

[41] Motion for Partial Summary Disposition, at 15-16.

Respondent 1 and Respondent 2 failed to set forth undisputed material facts as to the reasonableness of the firm's supervisory system to ensure timely reportable disclosures on a Form U4. Instead their motion essentially challenges the sufficiency of Enforcement's pleading. They claim that the Complaint did not specify what is missing from the procedures and failed to cite to any authority describing steps to be taken to ensure that Forms U4 are current.[42]

Respondent 1 and Respondent 2 have failed to set forth undisputed material facts concerning their supervision of Respondent 3 that supports summary disposition. There is nothing in the record that indicates that customers provided Movants with assurances sufficient to allay concerns about Respondent 3's trading activity. The Complaint provides ample detail about Respondent 2 and the firm's supervisory failings, which their motion fails to controvert. The Complaint alleges that Respondent 2 conducted no meaningful review of the trading activity notwithstanding the presence of red flags indicative of churning and unsuitable recommendations.[43] These include, according to the Complaint, a large number of transactions in the accounts (some of which were retirement accounts), an $81 per transaction charge, high cost-equity ratios, and that the accounts suffered losses between $52,000 and $166,000.[44] It also alleges that the procedures contained no description of controls that Movants would use to detect excessive trading and churning. Nor did the firm have exception reports targeting excessive trading that identified turnover rates or cost-to-equity ratios.[45]

With respect to deficient supervision relating to updating Forms U4 with material disclosures, the Complaint charges that Respondent 2 knew or had reason to believe that Respondent 3 was subject to tax liens but did not to make sure his Form U4 was updated. It also alleges that there were no written procedures setting forth, for example, how a broker could notify Respondent 1 of required disclosures and the timing and documentation of such disclosures.[46]

Respondent 1 and Respondent 2 have not shown that their supervision of Respondent 3 was adequate under the facts and circumstances of this case.[47] While they may be able to establish that the firm's procedures and supervisory system were reasonable, and that they properly supervised Respondent 3, these are factual matters that must be established by admissible evidence. They have offered no basis for their factual assertions and the allegations of the Complaint (which under Rule 9264(e) must be accepted as true) contradict their contention that their supervision of Respondent 3 was reasonable.

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[42] Motion for Partial Summary Disposition, at 16-17.

[43] Compl. ¶¶ 120-21, 137-38.

[44] Compl. ¶ 119.

[45] Compl. ¶¶ 92-95.

[46] Compl. ¶¶ 96, 140-41.

[47] *Dep't of Enforcement v. Pellegrino*, No. C3B050012, 2008 FINRA Discip. LEXIS 10, at *39 (NAC Jan. 4, 2008) ("Whether a particular supervisory system or set of written procedures is in fact 'reasonably designed to achieve compliance' depends on the facts and circumstances of each case.")

4. Movants' Statute of Limitations Argument has No Basis

Movants argue that there is an additional basis to dismiss the churning allegations contained in cause two. They claim that cause two must be dismissed on statute of limitations grounds. They rely on 28 U.S.C. §1658(b), which sets time limitations for private litigants – not self-regulatory organizations – to bring actions in cases involving violations of Section 10(b) of the Exchange Act. Without citing any evidence, Movants state that Enforcement filed its Complaint more than two years after it discovered facts constituting the violation.[48] The Complaint alleges that the fraudulent churning occurred from November 2008 to June 2012.[49] It is well-established that "the disciplinary authority of private self-regulatory organizations . . . such as NASD is not subject to any statute of limitations."[50]

Respondent 1 and Respondent 2 further argue that "Federal Law [] cannot be enforced by FINRA," and "the purpose of a hearing panel's finding of a 10(b) and 10b-5 violation is only to facilitate the SRO's ability to make a recommendation of enforcement by the Securities and Exchange Commission in Federal Court."[51] Movants cite to no authority for this proposition and there is no basis for the argument that FINRA lacks the authority to enforce federal securities laws and regulations.

III. Conclusion

The numerous allegations of the Complaint, together with the reasonable inferences that can be drawn from them, contradict Movants' contention that summary disposition is appropriate for the churning, unsuitable recommendations, and supervision charges. Genuine issues of material fact exist, and Respondent 1 and Respondent 2 are therefore not entitled to summary disposition. Furthermore, Movants' argument that the statute of limitations should be applied is rejected.

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[48] Motion for Partial Summary Disposition, at 13-14.

[49] Compl. ¶ 1. 28 U.S.C. § 1658(b) requires private litigants to bring an action involving a claim of fraud, deceit, manipulation, or contrivance concerning a violation of the securities laws "not later than the earlier of – (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."

[50] *Stephen J. Gluckman*, 54 S.E.C. 175, 185-86 (1999).

[51] Motion for Partial Summary Disposition, at 13.

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Accordingly, Respondent 1 and Respondent 2's motion for partial summary disposition is **DENIED**.

SO ORDERED.

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Michael J. Dixon
Hearing Officer

Dated: March 10, 2016