BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Keith Howard Medeck, Respondent.	DECISION Complaint No. E9B2003033701 Dated: July 30, 2009

Hearing Panel found that respondent had engaged in churning and excessive trading in a customer's account. The Hearing Panel barred respondent and ordered him to pay $41,493 to the customer in restitution. Held, the Hearing Panel's decision is reversed and the case is remanded to the Office of Hearing Officers for further proceedings.

Appearances

For Complainant: Leo F. Orenstein, Esq., Jonathan M. Prytherch, Esq., FINRA Department of Enforcement.

For Respondent: Theodore A. Krebsbach, Esq., Katherine M. McGrao, Esq., Krebsbach & Snyder, P.C., New York, NY.

I. Introduction

Respondent Keith Howard Medeck ("Medeck") appeals a December 12, 2006 Hearing Panel decision, which found that Medeck engaged in fraud by recommending an excessive number of trades (including options and short sales on margin[1]) in Customer SM's account at

[1] An "option" generally refers to an instrument that provides a right to buy or sell a security at a stated price. The failure to exercise the right after a specified period results in the expiration of the option. A "call option" is a right to buy the underlying stock and a "put option" is the right to sell the underlying stock. A "covered call" refers to a strategy in which an investor writes a call option while at the same time owning an equivalent number of shares of the underlying stock. *See generally* Staff of H. Comm. on Interstate and Foreign Commerce, 96th Cong., 1st Sess, Report of the Special Study of the Options Markets to the Securities and

[Footnote continued on next page]

Continental Broker-Dealer Corp. ("Continental") during a six week period, in violation of NASD Rules[2] 2120 and 2110, Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Exchange Act Rule 10b-5.[3] The decision also found that Medeck's excessive trading separately violated suitability requirements and thus NASD Rules 2110, 2310, 2860(b)(19), and NASD Interpretative Memorandum 2310-2.[4] The Hearing Panel barred Medeck in all capacities

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Exchange Commission, at 451-52 (1978) (hereinafter "Special Study of the Options Markets"); LAWRENCE G. MCMILLAN, OPTIONS AS A STRATEGIC INVESTMENT (1980); JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS (Barron's 4th Ed. 1995).

A "short sale" refers to the sale of a security not owned by the seller. Selling short generally is used when the seller believes that the price of the underlying stock will decline or to protect a profit in a long position. The investor essentially borrows the stock at the time of the short sale. If the investor can then buy the stock later at a lower price, the investor will profit from the transaction. *See id.*

[2] 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 the NASD Rule 9000 Series, as it existed on December 14, 2008. The conduct rules that apply are those that existed at the time of the conduct at issue.

[3] Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Rule 2120 prohibit associated persons from using manipulative, deceptive, or other fraudulent devices or contrivances in connection with the purchase or sale of any security. NASD Rule 2110 requires the observation of "high standards of commercial honor and just and equitable principles of trade." We note, as well, that NASD's rules apply to associated persons to the same extent as they do to member firms through application of NASD Rule 0115, which provides that "[p]ersons associated with a member shall have the same duties and obligations as a member under these Rules."

[4] NASD Rule 2310, which has three separate suitability obligations, discussed *infra*, generally requires associated persons to have reasonable grounds for believing that a recommendation is suitable for a customer based on his or her financial situation and needs. NASD Rule 2860(b)(19) similarly requires that a recommended *options* transaction not be unsuitable for the customer. Finally, the NASD Board of Governors' policy statement with respect to fair dealing with customers, which appears in the FINRA Manual following the suitability rule, provides in pertinent part as follows: "Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are . . . [e]xcessive activity in a customer's account. . . ." NASD IM-2310-2(b).

and ordered him to pay restitution of $41,493 and hearing costs of $5,024. We reverse the Hearing Panel's decision and remand the matter to the Office of Hearing Officers for further proceedings consistent with this opinion.

II. Respondent's Background

Medeck has worked in the securities industry since 1998. At the time relevant to this proceeding—December 16, 2002, through February 3, 2003—he was registered with Continental as a general securities representative and a corporate securities representative. Medeck is currently registered with another FINRA member firm.

III. Factual and Procedural History

As part of a broader examination of Continental, FINRA's Department of Enforcement ("Enforcement") opened an investigation into whether Medeck had engaged in sales practice abuses regarding Customer SM's account. Ultimately, that investigation resulted in Enforcement's filing of a complaint, on November 14, 2005, alleging that Medeck engaged in fraudulent excessive trading (known as churning) and unsuitable excessive trading. Medeck filed an answer denying the substantive allegations.

On February 24, 2006, Medeck's then counsel ("Initial Counsel") filed a motion under NASD Rule 9252 requesting that the Hearing Officer require Enforcement to issue NASD Rule 8210 requests to all broker-dealers at which Customer SM held accounts immediately before, during and immediately after the period under review, seeking account opening documentation and monthly account statements.[5] Prior to opening an account at Continental, Customer SM had an online securities account at member firm Morgan Stanley Dean Witter, which then became Harris Direct (hereinafter "Morgan Stanley/Harris Direct"). In addition, approximately one month before he closed his account at Continental, Customer SM opened a securities account at GunnAllen Financial, Inc. ("GunnAllen"). Medeck's Initial Counsel filed the motion approximately six months prior to the hearing but three days after the Hearing Officer's scheduling order deadline for filing such motions. The Hearing Officer denied Medeck's motion because it was late, failed to show that the information requested was relevant, and failed to show that he could not obtain it by other means.

On May 18, 2006, Medeck filed his expert's report, which referenced Customer SM's trading in his GunnAllen account and attached GunnAllen records for Customer SM. On June 5, 2006, Enforcement filed a motion to prevent Medeck from using the GunnAllen documents, the expert report, and the expert's testimony. In support of its motion, Enforcement argued that the GunnAllen information was not relevant because the complaint did not allege violations concerning trading recommended by another broker at a different firm. Enforcement also emphasized that Medeck could not have relied on the GunnAllen account information at the time

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[5] Rule 8210 authorizes FINRA to require members or their associated persons to provide information. Rule 9252 provides a mechanism for a respondent to request that FINRA invoke Rule 8210 to compel the production of documents or testimony at a hearing.

he was making recommendations to Customer SM while at Continental because all but a few of the GunnAllen trades occurred after the transactions in the Continental account. Enforcement also argued that the information should be excluded because it appeared to have been improperly obtained. Enforcement explained that the GunnAllen records were not part of Enforcement's investigative file, Customer SM did not consent to the release of the information to Medeck's Initial Counsel, and the Hearing Officer had previously rejected Medeck's request to have NASD obtain the information pursuant to NASD Rules 9252 and 8210.

Medeck's Initial Counsel opposed Enforcement's motion, arguing that the GunnAllen records were his primary evidence that Customer SM was a knowledgeable speculator who controlled his Continental trading and that preclusion would be prejudicial and constitute reversible error. Medeck's Initial Counsel stated that he contacted GunnAllen and that the firm hired him as counsel to protect itself from possible litigation by Customer SM because his trading at GunnAllen was as or more aggressive than at Continental. Medeck's Initial Counsel stated that GunnAllen authorized his use of the account statements regarding the expert report "[i]n order to protect itself from being victimized by [Customer SM's] obviously false statements." Medeck's Initial Counsel argued that GunnAllen had the legal right to release the documents "for the purpose of defending itself from the liability that may attach from the fraudulent actions of a former customer."

On July 17, 2006, the Hearing Officer ruled that GunnAllen did not have the right to release the information about Customer SM's account and granted Enforcement's motion to preclude Medeck from using or introducing Customer SM's GunnAllen account documentation. The Hearing Officer stated that "[w]hile GunnAllen might have a right to use customer account information to defend itself in a customer-initiated arbitration, this is not such a case. A customer who pursues an arbitration claim against a broker-dealer understands that he or she will be required to provide certain account information, thereby waiving his or her right to privacy. Here, however, [Customer] SM is only a witness, and GunnAllen is not a party to this disciplinary proceeding." The Hearing Officer did not rule on the expert's report and testimony at that time.

On August 3, 2006, the Hearing Officer granted in part and denied in part Enforcement's motion to exclude Medeck's expert's report and testimony. The Hearing Officer noted that the expert report addressed two central points. First, it questioned the methodology Enforcement used in its excessive trading analysis of Customer SM's account at Continental. Second, the report provided a comparative analysis of the trading in the Continental account and the GunnAllen account, mainly as a way to show that Customer SM understood and acquiesced in the type of trading at issue and that Medeck thus did not exercise *de facto* control over Customer SM's Continental account. The Hearing Officer determined that the expert report and testimony regarding the first point might be relevant and helpful to the Hearing Panel and denied Enforcement's motion in that regard. However, the Hearing Officer granted Enforcement's motion as to the second point. The Hearing Officer believed that the determination of whether Medeck exercised *de facto* control over the Continental account involved a factual analysis that was within the Hearing Panel's expertise. In addition, the Hearing Officer previously had ruled that Medeck could not use the customer's account documents GunnAllen improperly released to Medeck's Initial Counsel and used by the expert in his comparative analysis.

A. The Hearing

The hearing was held on August 16 and 17, 2006. Enforcement called as witnesses FINRA examiners John Clark and Gregory Marro, Customer SM, and Medeck. Medeck called as witnesses Robert Conner of Thornapple Associates, Inc., Medeck's expert on excessive trading calculations, and Joon Rhee, Medeck's former Continental branch manager.

1. John Clark

Clark, a FINRA senior examiner, testified that he participated in the examination of Continental and noticed "red flags" in Customer SM's account. Those red flags included possibly unsuitable recommendations, excessive commissions, and unsuitable options trading. Clark testified that Medeck admitted during an on-the-record interview that he had recommended the majority of transactions in Customer SM's account. However, Clark stated that Medeck did not recall anything about Customer SM's age, occupation, financial situation, and prior options and margin experience. Clark further testified that the trading in Customer SM's account generated approximately $14,000 in commissions. Clark, moreover, viewed as particularly problematic a high concentration in a short position in Acxiom Corp.

2. Gregory Marro

Marro, a FINRA senior examiner, testified that he took part in the examination of Continental that ultimately led to the charges against Medeck and that he prepared documents for Enforcement regarding the trading activity in Customer SM's account. He first noted that Customer SM's account raised a number of red flags, such as the use of the firm-wide options strategy that appeared calculated to generate commissions, active trading, use of margin, a high concentration in particular securities, and a written complaint from Customer SM. Marro also noted some discrepancies in Customer SM's account opening form and his options account opening form. On Customer SM's account opening form, dated November 1, 2002, the "investment objectives" section was left blank, the annual income was listed as $1 million to $2,499,999, and stated that he had ten years of investment experience in equities, bonds, commodities, and options. However, on the options form, dated December 11, 2002, Customer SM indicated that his investment objective was "income," he did not have any prior experience with options, his annual income was $100,000, and his total net worth was $200,000. Marro testified that he had to perform research before he understood the annual income and net worth figures listed on the options form because they were written as follows: "1,00,000" and "2,00,000." Marro testified that Customer SM, who immigrated to the United States from India, apparently used an "Indian numbering system" that "places a comma after the number, with then two zeros and a comma, and then the three zeros, to represent a hundred thousand."

Marro further testified that the trading during the review period generated total commissions of $14,227.17 and total losses of $26,629.16. According to Marro's calculations, the turnover rate (a measure of the volume of trading in an account) was 24 and the annualized rate was 97. Marro stated that the cost-to-equity ratio (the rate of return that is needed for the account to break even in light of commissions and other costs) was 134 percent and the annualized figure was 537 percent.

In addition, Customer SM's account had high concentrations in particular securities that Marro found troubling. For instance, in December 2002, the account had a short position in Acxiom of $153,800.[6] That position compared to the account equity of $20,849 in December 2002 represented 737 percent of Customer SM's account equity. Similarly, Customer SM's account held $40,200 worth of shares of H&R Block in December 2002, which represented 192 percent of the account equity. The account also had a $22,940 position in BEA Systems in December 2002, representing 110 percent of the account equity. In January 2003, the account held shares in QLogic worth $33,280, which represented 267 percent of the equity in the account at that time.

On cross-examination, Marro acknowledged that he had never been qualified as an expert in any proceeding. Marro also testified that he included in both his turnover and cost-to-equity analyses securities transactions that resulted from forced liquidations of equity positions ordered by a clearing firm rather than having been recommended by Medeck. Marro reasoned that such liquidations were properly captured in the analyses because they resulted from Medeck's original recommendations. Marro stated that he did not believe that he included options expirations in the analyses.

Medeck's Initial Counsel also questioned Marro on cross-examination about whether the actual figures for Customer SM's total net worth and annual income were $2 million and $1 million, respectively, in light of the way the amounts were written on the options account opening form (i.e., "2,00,000" for net worth and "1,00,000" for annual income). Marro reiterated his belief that Customer SM had intended to indicate that the amounts were $200,000 and $100,000 and that Customer SM had simply used an "Indian numbering system." Marro stated that he did not consult an expert on Indian math or culture. Instead, he had obtained the information on the Internet via "Wikipedia." Marro also acknowledged that another NASD examiner who questioned Medeck during his on-the-record interview apparently believed that Customer SM had indicated on the form that he had a net worth of $2 million rather than $200,000 and an annual income of $1 million rather than $100,000.

3. Customer SM

Customer SM testified that he was a software consultant who immigrated to the United States from India thirteen years earlier. He stated that he had separate university degrees in mathematical statistics and production and operations management. He testified during direct examination that, prior to opening the Continental account, he had an account with Morgan Stanley, which then turned into Harris Direct. He stated that the account was an online, self-directed account. He testified that he made the trading decisions and placed the orders himself. He said that the trades generally were "small trades." He admitted that he traded on margin, however. Customer SM stated that he opened an account with Medeck at Continental in November 2002 because he did not have time to continue making all the decisions for his

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[6] Marro testified and one of Enforcement's exhibits indicated that the Acxiom short position was valued at $153,800 in December 2002. We note, however, that FINRA's other testifying examiner, Clark, stated that the Acxiom short position was valued at "roughly $135,000."

account and he was impressed with Medeck's knowledge of the securities markets and the way Medeck presented himself. Customer SM's Morgan Stanley/Harris Direct account had a market value of approximately $42,000, which Customer SM transferred to Continental.

Customer SM testified that he told Medeck at the time he opened the account that he had a wife and two children and was the only family member who earned a living. He stated that he told Medeck that he only had three or four years of investment experience and had no experience with options or short selling. He further testified that he told Medeck that his annual income was between $120,000 and $125,000, his total net worth was approximately $200,000, and his liquid net worth was $120,000. Customer SM testified that Medeck recommended a trading strategy that involved options and short selling. He said that Medeck did not discuss the risks with him, but that he told Medeck that his objectives were growth and income and that Medeck should not be overly aggressive with the trading in his account. Customer SM stated that he did not understand how options or short selling worked.

Customer SM also testified that the information contained in the account opening form was wrong. He said that his net worth was $200,000, not $1 million to $2 million, and that he did not have ten years of investment experience with commodities and options. He said that he did not fill in the information and that he alerted Medeck that it was inaccurate but that Medeck told him it was only for record purposes and was unimportant. Customer SM said he then signed the form and sent it to Medeck. With regard to the figures representing his net worth ("2,00,000") and annual income ("1,00,000") on the options form, Customer SM testified that he grew up in India and that is how Indians wrote two hundred thousand and one hundred thousand. He said that he filled out the part of the form indicating that his average number of trades per year was ten.

Customer SM stated that Medeck recommended that he purchase securities using margin and that Medeck recommended the investments for his Continental account. He said that he relied on Medeck's experience and routinely followed Medeck's investment advice. He said that after the second week at Continental, he was not able to understand the trading in his account. Customer SM testified that the trading in his Continental account was inconsistent with his previous trading. On February 14, 2003, he wrote a letter to the firm complaining that he had lost nearly $25,000 in his account.

On cross-examination, Customer SM stated that he had been trading on margin since early 1998, at least four years before he opened his Continental account in November 2002. He also admitted during cross-examination that before opening his Continental account, he essentially was a day trader who purchased and sold penny stocks and other low-priced securities. He testified that his investment objectives were growth and income when he had an account at Morgan Stanley/Harris Direct. He testified that he believed his previous trading was consistent with those objectives, stating at one point that "there are tools for investors" that allow you to "benefit from short-term trading."

After some prodding, Customer SM acknowledged that he had opened an account at GunnAllen approximately one month prior to his closing the account at Continental. (He initially claimed that he had not opened the GunnAllen account until after he had closed the Continental account.) Customer SM then stated that he indicated on the GunnAllen account

opening form that his investment objectives were growth and income, his net worth was $200,000 or lower, and his options experience was two months. Medeck's Initial Counsel then attempted to use the GunnAllen records to impeach Customer SM's testimony, but Enforcement objected. The Hearing Panel held a hearing with counsel outside the presence of witnesses regarding Enforcement's objection.

Enforcement argued that Medeck's Initial Counsel's line of questioning was precluded by the Hearing Officer's order excluding the GunnAllen records. Enforcement also argued that GunnAllen should not have provided the records to Medeck's counsel because doing so violated Customer SM's privacy and that, in any event, the records were irrelevant. Medeck's Initial Counsel argued that the GunnAllen documents were needed to impeach Customer SM's testimony. He proffered that the documents would show that Customer SM testified falsely about what he told GunnAllen regarding his annual income and options experience. Medeck's counsel argued, moreover, that he also represented GunnAllen on other matters and that GunnAllen was free to share Customer SM's account information with its counsel without Customer SM's permission because they had potential exposure from the customer.[7]

The Hearing Officer indicated that he had not reviewed and did not intend to review the GunnAllen records. The Hearing Officer reiterated that his previous ruling on the exclusion of the GunnAllen records remained in force. He indicated during the hearing that his exclusion of the records resulted in large part because Medeck's counsel had obtained the documents without Customer SM's consent. The Hearing Officer acknowledged for the first time, however, that information about Customer SM's GunnAllen account was potentially relevant on two grounds. First, it could be relevant regarding Customer SM's credibility. Second, it could be relevant regarding whether Medeck had *de facto* control over the account, which is an element of excessive trading actions. The Hearing Officer opined that evidence that a customer engaged in similar trading activity at another broker-dealer during or immediately after the period under review somewhat undercut the argument that the customer was incapable of understanding the activity at the first broker-dealer. As a result, the Hearing Officer stated that he would permit Medeck's counsel to ask Customer SM questions about his GunnAllen account, but would not allow him to use the documents. Medeck's Initial Counsel argued that proceeding in such a manner would allow Customer SM to continue to testify falsely. The Hearing Officer refused to modify his order regarding the use of the documents, however.

When cross-examination of Customer SM resumed, Medeck's counsel asked whether Customer SM recalled telling Medeck's Continental branch manager, Joon Rhee, that he wanted to short sell Acxiom and intended to add money to his account after a company in which he had an ownership interest was sold. Customer SM denied that he ever had such a conversation. Medeck's Initial Counsel then asked about the trading activity in Customer SM's GunnAllen account. Customer SM admitted that he continued to purchase and sell options on margin and

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[7] GunnAllen subsequently stated in correspondence with Enforcement that, although Medeck's Initial Counsel had represented GunnAllen on some other matters, GunnAllen had not hired him to represent GunnAllen regarding Customer SM and that GunnAllen had inadvertently provided Customer SM's records to him.

engaged in "short day trading kind of thing" on occasion. He denied that the trading in the GunnAllen account was more active than the trading in the Continental account, but he acknowledged that the nature of the trading was similar.

Medeck's counsel then asked Customer SM whether he indicated on the GunnAllen new account form that his (1) investment objective was trading and speculation, (2) trading experience in stocks, bonds, and options was extensive, including 10 years of experience with options, and (3) net worth excluding residence was $500,000. Customer SM responded to each of these questions by stating "I don't remember." When asked whether he had more than 20 options trades in February 2003 at GunnAllen, Customer SM replied that 20 was too high and that he might have had five options trades in February 2003, but that he would have to look at the record to be sure. When Medeck's Initial Counsel offered to show him his GunnAllen trading records to refresh his recollection, Enforcement objected and the Hearing Officer did not allow him to use the records.

4. Medeck

Medeck stated that he took over Customer SM's account after it had been opened by another broker and that he learned from speaking with Customer SM directly that his investment objectives were "speculation and short-term trading." He also testified that Customer SM's investment profile on the firm's automated system indicated that Customer SM's investment objectives were "speculation and short-term trading." Medeck stated that the automated investment profile was created by someone "in the back office." Medeck testified that Customer SM never told him his investment objectives were "growth and income." Medeck further stated that Customer SM's net worth was $1.5 to $2.5 million. In addition, Medeck stated that Customer SM told him that he had recently sold his company for several million dollars. Medeck emphasized, moreover, that Customer SM was approved to trade options.

Medeck admitted that he recommended many, but not all, of the transactions in Customer SM's account. With regard to the Acxiom short transaction, for instance, he testified that he only "recommended shorting a couple of thousand shares." Medeck stated that it was Customer SM's idea to short 10,000 shares of Acxiom and that he recommended against shorting such a large amount. Medeck also stated that he wanted to hedge the entire position with call options but that Customer SM would only allow a partial hedge. Customer SM ultimately purchased 75 call options, which protected 7,500 shares of the 10,000 Acxiom short sale. The remaining 2,500 shares were worth close to $40,000 at the time. Medeck also testified that he did not recommend the opening transaction in the account because the account was opened by another broker. In contrast to Enforcement's claim, Medeck testified that he did not recommend liquidating the Acxiom position or others in February 2003. Customer SM did not have sufficient assets in his account to maintain the Acxiom short position under Federal Reserve Regulation T, which regulates the extension of credit to customers by broker-dealers, and he failed to deposit additional funds into the account. As a result, Continental's clearing firm liquidated the position on February 3, 2003, along with many others.

Medeck testified, moreover, that the option trades he recommended to Customer SM were "pretty basic" and not complex. According to Medeck, writing covered calls, buying protective puts, and buying calls to hedge a short position represent a fairly conservative

strategy. The writing of call options against long positions, moreover, was calculated to generate income, which was consistent with Customer SM's stated options investment objective. Medeck asserted that he did not trade options very aggressively. With regard to the Acxiom short sale, Medeck argued that he did not recommend the amount that Customer SM decided to short and that Customer SM told him that he would be using funds from the sale of a business to pay for the short sale.

5. Joon Rhee

Joon Rhee testified that he was Medeck's supervisor during the period in question. He stated that he had called Customer SM as a courtesy to let him know that the clearing firm was going to liquidate various positions, including the Acxiom position, because Customer SM had failed to pay for the Acxiom transaction. Rhee testified that Customer SM told him that he had expected to receive money from the sale of a business but that the sale had been delayed. Rhee testified that the telephone conversation was tape recorded.

Enforcement raised a twofold objection to the use of the audiotape. First, Medeck failed to inform Enforcement that it was a possible exhibit. Second, the audiotape might have been recorded in violation of state law depending on where the parties resided and whether Customer SM was aware his conversation was being recorded.

The Hearing Officer then asked Rhee whether he had informed Customer SM about the recording. Rhee testified that he did not mention it to Customer SM. The Hearing Panel then sustained Enforcement's objection.

6. Robert E. Conner

Medeck's expert witness, Robert E. Conner, disputed the validity of Enforcement's turnover rate calculation on a number of grounds. First, he explained that options generally are not amenable to a turnover analysis because they are short-term instruments, they inherently represent leverage, and combining them with other instruments (such as the underlying equity security) confuses the measurements. Statistical measurements, moreover, fail to take into account subjective reasons for purchasing options. For instance, purchasing XYZ stock and purchasing an option on XYZ stock to hedge the customer's position may be calculated as two transactions but they are very much related. Conner explained that it is not really probative to consider those as separate, unrelated trading volumes. One is designed to affect the risk of exposure of the other. Such determinations make the analysis more complex then simply looking at turnover numbers.

Second, Conner testified that Enforcement failed to confine its computation to transactions Medeck recommended. Conner contended that Enforcement should have excluded any transaction initiated by Continental's clearing firm to clear a margin deficiency because those transactions do not represent activity Medeck directed.

Third, Conner testified that option closing transactions should not be included. In Conner's opinion, a single turnover or "cycle" for an option trade is comprised of the opening and closing transactions. Thus, only the opening transaction should be counted to determine the rate of turnover.

Fourth, Conner argued that Enforcement improperly based its computation on the account's "net equity," without taking into consideration the distorting effect of margin debt. Conner gave the example that a $30,000 stock portfolio of unchanged market value that is turned over three times in a year is said to have a turnover rate of three. However, using Enforcement's methodology, the same portfolio financed with 50 percent margin debt would have a turnover rate of six, even though there is no difference in the activity in the account. Conner argued that the resulting inflation caused by margin debt leaves Enforcement's computation without any probative value in determining if the activity was excessive. Conner admitted, however, that it is common to use net equity when calculating both turnover rates and cost-to-equity ratios. In fact, Conner used net equity in his calculations.

Fifth, Conner stated that Enforcement erred by annualizing trading activity that occurred during a period of only six weeks. Conner explained, "As with any statistical measure, the smaller the base upon which you base a measurement, either in size or in this case duration, the more tenuous the conclusion you try to extend it to an annualized basis."

Conner presented alternative calculations. He calculated the turnover rate both for the account as a whole and for the account with the Acxiom short sale excluded. Conner excluded the Acxiom short sale because the customer failed to add more funds to maintain the position, which was out of Medeck's control and unfairly distorts the measurements. However, he did use net equity in his calculations, even though he believes it inappropriately raises the ultimate numbers. Conner testified that the turnover rate was 2.9 and the annualized turnover rate was 10.9. Without the Acxiom transactions, he calculated that the turnover rate was 0.9 and the annualized turnover rate was 3.3.

As with the turnover rate calculations, Conner asserted that Enforcement's cost-to-equity ratio calculations were faulty. Conner explained that Enforcement included transactions that Medeck did not recommend and inappropriately used net equity. He also similarly argued that the Acxiom short sale should not have been included as the numbers would be substantially and artificially increased by Customer SM's failure to pay for the transactions—an act entirely outside Medeck's control. According to Conner's calculations (all of which used net equity), the cost-to-equity ratio was 21 percent and the annualized cost-to-equity was 79.8 percent. Without the Acxiom transactions, the cost-to-equity ratio was 8.6 percent and the annualized cost-to-equity ratio was 32.7 percent.

B. The Hearing Panel's Conclusions and the Appeal

The Hearing Panel concluded that Medeck's trading was unsuitable and fraudulent. According to the Hearing Panel, Medeck recommended a level of trading that was clearly excessive, as demonstrated by the turnover rate and the cost-to-equity ratio for the account. The Hearing Panel barred Medeck in all capacities and ordered him to pay restitution to Customer SM in the amount of $41,493. The Hearing Panel also required Medeck to pay $5,024 in hearing costs. Medeck then appealed.

IV. Discussion

Enforcement alleged, and the Hearing Panel found, that Medeck violated FINRA's suitability and anti-fraud provisions by engaging in excessive trading in Customer SM's account. That is, Enforcement's complaint and the Hearing Panel's decision focused on the frequency of the trading rather than the characteristics of any particular recommended security or strategy. We reverse the decision and remand the case because we are unable to sustain the Hearing Panel's findings of unsuitable and fraudulent excessive trading based on the current record. A full understanding of the elements needed to prove the causes of action alleged in the complaint is instructive.

There are three main suitability obligations. First, a broker must have a reasonable basis to believe, after performing adequate due diligence, that the recommendation could be suitable for *some* investors ("reasonable-basis suitability").[8] Second, a broker must have reasonable grounds to believe that the recommendation is suitable for the specific customer at issue ("customer-specific suitability").[9] Third, a broker must have reasonable grounds to believe that the number of recommended transactions within a particular period is not excessive ("quantitative suitability").[10]

This case focuses on the third type of obligation, quantitative suitability, which is doctrinally distinct from the other two suitability theories. Customer-specific and reasonable-basis suitability focus on the quality of a recommended security. Quantitative suitability, on the other hand, focuses not on the underlying characteristics of a particular security but on whether the number of transactions within a given timeframe is suitable in light of the customer's financial circumstances and investment objectives.[11] Put another way, certain recommended

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[8] *See Michael Frederick Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, *28-31 (Oct. 6, 2008), *petition for review filed*, No. 08-1379 (D.C. Cir. Dec. 3, 2008); *F.J. Kaufman and Co.*, 50 S.E.C. 164, 168 & n.16 (1989).

[9] *See Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *23-24 (Feb. 10, 2004); *Patrick G. Keel*, 51 S.E.C. 282, 284-87 (1993); *Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NASD NAC Aug. 9, 2004).

[10] *See Harry Gliksman*, 54 S.E.C. 471, 474-75 (1999).

[11] *See O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992) (noting that "churning deals with the quantity of securities purchased for an account, while [the usual] unsuitability concerns the quality of the purchased securities"); *see also Wayne Miller*, Exchange Act Rel. No. 45738, 2002 SEC LEXIS 912, at *7 (Apr. 11, 2002) ("excessive trading in the account in light of the customer's investment objectives"); Special Study of the Options Markets, *supra* note 2, at 450 ("The nature of the account must be considered since the trading in an account need not only be active but must also be inconsistent with the financial circumstances and investment objectives of the customer.").

transactions, viewed individually, might be suitable for a customer under customer-specific and reasonable-basis analyses, but those same recommended transactions, taken together, may be excessive and quantitatively unsuitable for that same customer.[12]

A cause of action based on quantitative suitability also requires elements of proof that are not necessary under the other theories. The first element of this type of action is broker control over the account in question.[13] This element is satisfied if the broker has either discretionary authority[14] or *de facto* control over the account.[15] *De facto* control is established when the client

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[12] Enforcement's complaint focused on excessive trading and churning save for brief references to the unsuitability of the Acxiom short sale and the use of margin. Even then, the references to the short sale and use of margin appear tied to Enforcement's excessive trading and churning theories rather than creating standalone causes of action for customer-specific or reasonable-basis suitability. For instance, Enforcement included the Acxiom short sale and margin in its calculations for turnover rate and cost-to-equity ratio to show excessive trading and rarely mentioned the short sale and margin outside of that context.

The Hearing Panel's decision similarly focused on excessive trading and churning. The decision did not make separate findings regarding the unsuitability of the Acxiom short sale or use of margin. Under the heading "Suitability—Excessive Trading," the decision analyzed the turnover rate, cost-to-equity ratio, concentration of investments in three particular securities (H&R Block, Inc., Bea Systems, Inc., and QLogic Corp.), and use of margin. In that same section, the decision then concluded simply that Medeck had engaged in excessive trading. The only section in the decision where the Hearing Panel focused on a suitability violation other than excessive trading was when it found that Medeck's recommendation that Customer SM trade options was unsuitable and a violation of NASD Rule 2860. However, Enforcement did not plead (or prosecute) the case on that theory. The complaint cited NASD Rule 2860, along with a number of other rules, as part of Enforcement's excessive trading cause of action. The complaint did not state that Medeck's recommendation that Customer SM trade options (or trade a particular option or engage in a particular options strategy) violated NASD Rule 2860. To the extent that the Hearing Panel relied on such a finding, it is hereby reversed as inconsistent with fair notice requirements. *See James W. Browne*, Exchange Act Release No. 58916, 2008 SEC LEXIS 3113, at *36-37 (Nov. 7, 2008) (fairness requires that "specific charges be brought, that notice be given of such charges, [and] that an opportunity to defend against such charges be given"); *James L. Owsley*, 51 S.E.C. 524, 527-28 (1993) (same); *Paulson Inv. Co.*, 47 S.E.C. 886, 890 (1983) (same).

[13] *Gliksman*, 54 S.E.C. at 474-76; *Pinchas*, 54 S.E.C. 331, 337 (1999).

[14] *See Peter C. Bucchieri*, 52 S.E.C. 800, 805 n.11 (1996) ("If a broker is formally given discretionary authority to buy and sell for the account of his customer, he clearly controls it."). Moreover, where the broker has discretionary authority (or engages in unauthorized trading), the transactions are deemed to have been implicitly recommended for purposes of the suitability rule. *See Pinchas*, 54 S.E.C. at 341; *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992).

routinely follows the broker's advice "because the customer is unable to evaluate the broker's recommendations and to exercise independent judgment."[16] The second element is excessive trading activity inconsistent with the customer's financial circumstances and investment objectives.[17] Although there is no single test for what constitutes excessive activity, factors such as turnover rate,[18] cost-to-equity ratio,[19] and use of "in and out" trading in an account may provide a basis for a finding of excessive trading.[20] Where, as here, Enforcement also alleges fraud as part of the purported excessive trading, often referred to as "churning" in the fraud context, Enforcement must prove scienter as part of its case. Scienter requires proof that a

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[cont'd]

15 *Gliksman*, 54 S.E.C. at 475 (citing *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983); *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676-77 (9th Cir. 1982); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980)).

16 *See Gliksman*, 54 S.E.C. at 475; *see also Pinchas*, 54 S.E.C. at 337-38 (finding *de facto* control where one customer had no prior investing experience and did not speak or read English and another had elementary-school-level skills in reading and arithmetic and could not grasp even simple trading concepts).

17 *Pinchas*, 54 S.E.C. at 337.

18 The turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." *Pinchas*, 54 S.E.C. at 339-40 n.14; *see also Allen George Dartt*, 48 S.E.C. 693, 695 (1987); Special Study of the Options Markets, *supra* note 2, at 451-57.

19 This is sometimes expressed as the "break-even cost factor." The phrases refer to identical calculations. *See Donald A. Roche*, 53 S.E.C. 16, 22 (1997). This calculation represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses[,]" such as margin interest. *Pinchas*, 54 S.E.C. at 340. Put another way, because of the transaction costs related to trading, the account would need to appreciate that amount to break even. *See Frederick C. Heller*, 51 S.E.C. 275, 276-77 (1993).

20 The term "in and out" trading refers to the sale of all or part of a portfolio, with the money from the sale being reinvested in other securities, followed by the sale of the newly acquired securities. *See Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).

respondent intended to deceive, manipulate, or defraud,[21] or "acted with severe recklessness involving an extreme departure from the standards of ordinary care."[22]

Enforcement alleged and the Hearing Panel found that Medeck engaged in churning and excessive trading. For the reasons discussed below, we are unable to reach the same conclusions based on the current record. We therefore reverse the Hearing Panel's decision and remand the matter for further proceedings consistent with the discussion herein.

A. Control of the Account

The first step in analyzing an action based on excessive trading/churning is to determine whether the broker controlled the account. Enforcement did not allege that Medeck had discretionary authority over the account. However, Enforcement alleged, and the Hearing Panel found, that Medeck did have *de facto* control over the account. The Hearing Panel stated that Medeck controlled the account because Customer SM "lacked the time and expertise to manage his own account" and "had no experience with options or short selling." The proper inquiry, however, is whether Customer SM was "unable to evaluate" Medeck's recommendations and was unable "to exercise independent judgment."[23] Indeed, evidence focusing on Customer SM's decisionmaking, investment objectives, finances, and experience, although less than a model of clarity, casts doubt on the Hearing Panel's finding of *de facto* control.

Customer SM has college degrees in mathematical statistics and production and operations management. He testified that for approximately four years prior to opening his account at Continental he had traded technology and internet stocks on margin in his self-directed online brokerage account at Morgan Stanley/Harris Direct. He stated that he understood the risks and rewards of his margin trading. He also acknowledged that he day traded stocks priced less than $5 before opening his Continental account. Customer SM further testified that his investment objectives for his account at Morgan Stanley/Harris Direct and his account at Continental were "growth/income." He conceded, however, that his definition of "growth/income" included his unsolicited day trading of low-priced stocks on margin.

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[21] *See Aaron v. SEC*, 446 U.S. 680, 686-87 n.5 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

[22] *See Dep't of Enforcement v. Reynolds*, Complaint No. CAF990018, 2001 NASD Discip. LEXIS 17, at *44 & n.27 (NASD NAC June 25, 2001) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991); *In re Baesa Secs. Lit.*, 969 F. Supp. 238, 241 (S.D.N.Y. 1997)).

[23] *See Gliksman*, 54 S.E.C. at 475; *see also Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977) ("[I]f a customer is fully able to evaluate his broker's advice and agrees with the broker's suggestions, the customer retains control of the account."); *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982) ("[A]s long as the customer has the capacity to exercise the final right to say 'yes' or 'no' the customer controls the account.").

The Continental new account form that Customer SM and his wife signed indicated that they had $100,000-$149,999 annual income and $1,000,000-$2,499,999 total net worth. The new account form also indicated that Customer SM's investment experience included ten years of trading in equities, bonds, commodities, and options. The investment objective section of the form was left blank. On the Continental options form, Customer SM handwrote that he had "$2,00,000" net worth and "$1,00,000" annual income. Medeck testified, and an Enforcement staff member indicated his belief during on-the-record questioning of Medeck, that those figures indicated that Customer SM's net worth was $2 million and his annual income was $1 million.[24]

Customer SM admitted that he signed the Continental account opening and options forms, as well as a margin agreement, and that he knew that Medeck planned to propose strategies that included options, short sales, and margin. Medeck, moreover, testified that Customer SM told him his investment objectives were "trading and speculation." In addition, Medeck and his former supervisor, Rhee, both testified that Customer SM stated that he had recently sold a company for several million dollars.

As discussed more thoroughly in the "Evidentiary Issues" section of this decision, moreover, Customer SM had an account at another broker-dealer—GunnAllen—during and immediately after the period when he had an account at Continental. The trading in the GunnAllen account was similar in nature to the trading in the Continental account. The GunnAllen records also indicated that Customer SM's experience with options and short selling was extensive and that his net worth was $500,000.

Perhaps most important, however, is Medeck's testimony that he recommended that Customer SM short sell one or two thousand shares of Acxiom and that Customer SM fully cover the short sale with call options. According to Medeck's testimony, which was not contradicted during the hearing, Customer SM rejected his recommendation and instead decided to short sell 10,000 shares of Acxiom and cover only part of the position. If such actions did occur, they appear inconsistent with a finding of *de facto* control over an account.

Because it is not entirely clear that the Hearing Panel considered all of this information or that it applied the correct legal standard, we remand this matter for further proceedings on the issue of *de facto* control. In considering the totality of the evidence, including, as discussed below, the GunnAllen records that are part of the supplemental record of this case, the Hearing Panel shall determine whether Medeck had *de facto* control over the account because Customer SM was "unable to evaluate" Medeck's recommendations and was unable "to exercise independent judgment." The Hearing Panel also shall include a discussion of the evidence that supports its findings.

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[24] The options form, however, also indicated that Customer SM's options investment objective was "income" and that he did not have any prior experience with options.

B. Excessive Trading

There is no single test for determining whether the trading activity in an account was excessive. As the Securities and Exchange Commission has explained, the "assessment of the level of trading . . . does not rest on any 'magical per annum percentage,' however calculated." *Gerald E. Donnelly*, 52 S.E.C. 600, 603 (1996). Nonetheless, factors such as the turnover ratio, the cost-to-equity ratio, the use of "in and out" trading, and the number and frequency of trades in an account introduce some measure of objectivity or certainty into the analysis and provide a basis for a finding of excessive trading. *See Costello*, 711 F.2d at 1369; *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435-36 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *John M. Reynolds*, 50 S.E.C. 805, 808 n.12 (1991).

Turnover rates greater than six generally have triggered liability for excessive trading.[25] Excessive trading also has been found in cases in which the cost-to-equity ratio was in excess of 20 percent.[26] With regard to evidence of "in and out" trading, the United States Court of Appeals for the Seventh Circuit has noted that "[i]t is a practice extremely difficult for a broker to justify." *Costello*, 711 F.2d at 1369 n.9.

Here, Enforcement relied on the turnover rate and the cost-to-equity ratio to show that the trading was excessive. According to its calculations, the turnover rate during the review period was 24 and the annualized rate was 97. Enforcement also indicated that the cost-to-equity ratio was 134 percent and the annualized figure was 537 percent. If accurate, those numbers generally would support a finding of excessive trading. Indeed, even Medeck's expert's lowest annualized cost-to-equity ratio of 32.7 percent is above the normal threshold of 20 percent as an indicator of excessive trading. This case, however, raises issues that are not ordinarily present in cases relying on theories of excessive trading/churning.

As an initial matter, this case involves options, which are by their very nature short-term instruments. The majority of suitability cases involving options are brought not under an excessive trading/churning theory but rather on the basis that any options trading is inconsistent with the customer's financial situation and investment objectives. Not only are options short-term instruments that tend to be traded more frequently then other types of investment instruments, but normal guideposts for excessive trading do not work particularly well when

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[25] *See, e.g., Peter C. Bucchieri*, 52 S.E.C. 800, 805 (1996) ("[W]hile there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading.") (citing *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980)); *Shearson Lehman Hutton Inc.*, 49 S.E.C. 1119, 1122 (1989) (same).

[26] *See Pinchas*, 54 S.E.C. at 340 (explaining that "cost-to-equity ratio in excess of 20% indicates excessive trading"); *see also Bucchieri, supra*, at 801-03 (finding that cost-equity ratio for accounts of 22.4 percent, 25.6 percent, 21.8 percent, and 24.9 percent supported finding of excessive trading); *Michael David Sweeney*, 50 S.E.C. 761, 763-65 (1991) (cost-equity ratios of 27 percent, 44 percent, 36 percent, and 22 percent indicated excessive trading).

options are involved.[27] Indeed, the Special Study of the Options Markets emphasized, and we have opined on occasion, that turnover rates often are poor indicators of excessive trading in options cases and that cost-to-equity ratios are the better measurements.[28]

Although the Hearing Panel relied more heavily on the cost-to-equity ratio than the turnover rate, there is substantial dispute between the parties, and a less then clear record, regarding the accuracy of both parties' cost-to-equity calculations.[29] On remand, the Hearing Panel should first determine which securities Medeck recommended. If a registered representative recommends transactions on margin, the commissions and interest charges associated with those transactions should be included in the cost calculation. As mentioned above, however, Medeck testified, without contradiction, that he recommended that Customer SM only short sell one or two thousand shares of Acxiom rather than the 10,000 shares the customer decided to short. In fact, Medeck testified that he explicitly told Customer SM to refrain from shorting such a large amount.[30] The suitability obligation extends only to those transactions that are recommended. The costs associated with transactions that were not recommended should not be included in the calculation.[31]

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[27] *See* Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 Bus. Law. 571 (1984) ("Because of the complexity of listed options and the variety of ways in which they may be used, mathematical measurements of the amount of trading are considerably less useful in options cases in order to reach a determination as to whether the broker has acted inconsistently with his duty to his customer.").

[28] *See* Special Study of the Options Markets, *supra* note 2, at 453-54 (explaining that turnover rate does not adequately measure the impact of options trading on the activity in customer accounts and that cost-to-equity ratios provide a more accurate basis for comparison of accounts using various investment vehicles); *Dep't of Enforcement v. Pinchas*, No. C10930017, 1998 NASD Discip. LEXIS 59, at *19 n.21 (NAC June 12, 1998) (declining to analyze whether options trading in case was excessive and noting that cost-to-equity ratio is better indicator of excessive trading when options are involved), *aff'd*, 54 S.E.C. 340 (1999); *Dist. Bus. Conduct Comm. v. Black & Co.*, No. SEA-477, 1990 NASD Discip. LEXIS 11, at *35 (NASD Bd. of Governors Jan. 9, 1990) (explaining that options trading skews the turnover rate calculation).

[29] Enforcement is not precluded from offering and Hearing Panels are not precluded from relying on turnover rates when options are involved. There are cases involving options where the trier of fact relied on such evidence. *See, e.g.*, *Miller*, 2002 SEC LEXIS 912, at *3, *8-9 (noting turnover rates in case involving options). However, cost-to-equity ratios remain the stronger indicator of excessive trading in options cases.

[30] Medeck also testified that he recommended that Customer SM cover the entire position with call options but that Customer SM reluctantly agreed to cover only part of the position. According to Medeck's testimony, Customer SM at first refused to cover the position at all.

[31] To the extent that the Hearing Panel relies on evidence of the turnover rate for the account, the same concept holds true in that context as well. Only those trades that were

[Footnote continued on next page]

Next, Medeck's expert witness testified that the smaller the sample on which an "annualized" calculation is based, either in size or in this case duration, the more tenuous the conclusion. Annualizing turnover rates and cost-to-equity ratios is commonplace and can be useful for comparison purposes, but the Hearing Panel should note and consider the limitations, if any, of doing so when the period in question is particularly short (approximately six weeks in this case).[32]

With regard to both the turnover rate and the cost-to-equity ratio, the parties disagree on whether the calculations should use equity or net equity. Enforcement stated that the standard way of calculating both turnover rates and cost-to-equity ratios is to use net equity. Medeck argues that using net equity inappropriately increases the turnover rate and cost-to-equity ratio (i.e., as the denominator decreases, the turnover and cost-to-equity numbers increase). Medeck concedes, however, that most turnover and cost-to-equity calculations use net figures. Medeck's expert, moreover, used net equity in his own calculations. We agree with Enforcement and numerous decisions that the better approach is to use net equity, which necessarily excludes from the calculations the amounts invested using margin.[33] Turnover rate and cost-to-equity ratio appropriately provide measurements of the trading and costs in relation to the size of the account, and the true size of the account must include a deduction for borrowed funds.

In addition to these issues, however, it also must be remembered that "the trading in an account need not only be active but must also be inconsistent with the financial circumstances

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[cont'd]

recommended should be included in the analysis. That would preclude amounts beyond those that were actually recommended, options that expired, and any liquidating transactions related to a margin call that were initiated not by Medeck but by the clearing firm.

[32] We do not mean to suggest that an annualized figure cannot be used in such circumstances. Rather, depending on the facts and circumstances of the particular case, the trier of fact could view the length of the actual trading period as impacting the persuasiveness of the annualized figure for a variety of reasons. For instance, the trier of fact could give less weight to annualized figures 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. Other factors, such as the customer's investment objectives and financial situation and needs, as well as the reasonableness of the respondent's explanation for the trading, also are important considerations in such circumstances.

[33] *See, e.g.*, *Willam 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.") (emphasis added); *Pinchas*, 54 S.E.C. at 339-40 n.14 (explaining that turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment[,]" which "is the cumulative total of the *net investment* in the account at the end of each month, *exclusive of loans*, divided by the number of months under consideration") (emphasis added).

and investment objectives of the customer."[34] The record is murky on these topics as well. For instance, Customer SM left the investment objectives section of the account opening form blank. Although he testified that he told Medeck that his objectives were growth and income and the options account opening form indicated his objective was income, he also testified that he believed that day trading speculative stocks on margin was consistent with his view of growth and income.[35] Irrespective of the exact language used, the Hearing Panel should determine the nature of the trading in which Customer SM desired to engage and the reasonableness of Medeck's belief that Customer SM's objectives were speculation and short-term trading.

The record also is cloudy regarding Customer SM's financial situation at the time in question. Customer SM asserted at the hearing that his annual income was $125,000 and his net worth was $200,000 during the period in question. He also claims to have conveyed that information to Medeck, which Medeck denied. In addition, the Continental new account form that Customer SM and his wife signed indicated that they had $100,000-$149,999 annual income and $1,000,000-$2,499,999 total net worth. On the Continental options form, Customer SM handwrote that he had "$2,00,000" net worth and "$1,00,000" annual income. Even one of the Enforcement staff who originally questioned Medeck believed that Customer SM's handwritten note indicated that his net worth was $2 million and his annual income was $1 million. Medeck and Rhee both testified, moreover, that Customer SM claimed that he would soon be selling a business worth millions of dollars. In light of this information, the Hearing Panel should determine whether it was reasonable for Medeck to believe that Customer SM had greater wealth than he claimed to have had during the hearing or even than he actually had during the period in question.

C. Scienter

In finding that Medeck violated the anti-fraud provisions by churning the account, the Hearing Panel found that Medeck acted with scienter. As discussed above, scienter requires proof that a respondent intended to deceive, manipulate, or defraud, "or that he acted with severe recklessness involving an extreme departure from the standards of ordinary care."[36] The Hearing Panel's entire discussion of scienter is as follows:

> Finally, the Panel finds that Medeck acted with scienter. The Panel concludes that Medeck engaged in the transactions in

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[34] *See* Special Study of the Options Markets, *supra* note 2, at 450; *see also Miller*, 2002 SEC LEXIS 912, at *7 (explaining that it's "excessive trading in the account in light of the customer's investment objectives").

[35] Customer SM also testified that his investment objectives were the same for all of his accounts and that his investment objectives at GunnAllen were income and growth. However, the GunnAllen documents attached to the supplemental record appear to indicate that Customer SM's investment objectives were trading and speculation.

[36] *See Reynolds*, 2001 NASD Discip. 17, at *44 n.27.

> [Customer] SM's account in order to generate commissions, in disregard of [Customer] SM's interests. At a minimum, Medeck acted with a reckless disregard of [Customer] SM's interests. In conclusion, the Panel finds that Medeck defrauded [Customer] SM by churning his account, in violation of Section 10(b) of the Securities Exchange Act, Exchange Act Rule 10b-5, NASD conduct Rules 2120 and 2110.

Circumstantial evidence, such as excessive trading activity and high costs inconsistent with the customer's investment objectives and financial situation, can be used to prove scienter. Nevertheless, something more than the Hearing Panel's cursory explanation is required. Assuming, *arguendo*, that the other elements of churning exist, the Hearing Panel should discuss, at a minimum, whether 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 involving an extreme departure from the standards of ordinary care.

D. Evidentiary Issues

In most cases involving allegations of unsuitable trades, information about a customer's trading activity at other broker-dealers (before, during, or after the trading at issue) is irrelevant.[37] What matters is the suitability of the trade(s) at issue. For a variety of reasons, however, this case is somewhat unusual. It involves allegations of excessive trading/churning (rather than reasonable-basis or customer-specific suitability), which often requires an analysis of whether the respondent had *de facto* control over the account. That issue, in turn, requires a determination of whether the customer had the ability to understand and independently evaluate the recommended trading. In some instances, factors that would help resolve these issues, such as the customer's investment experience and sophistication, are readily apparent. Not so here. Customer SM testified that he did not understand the trading in his account. Conversely, Medeck testified that Customer SM was an experienced and sophisticated investor who understood and approved the trading. The account opening form, moreover, appears to indicate that Customer SM had greater investment experience and resources than he indicated during his testimony.

Under these circumstances, a customer's investment experience at another broker-dealer (before, during, and even immediately after the trading at issue), while perhaps not dispositive, could shed light on whether the customer had the ability to understand and make independent

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[37] *See, e.g., Dist. Bus. Conduct Comm. v. Vaughan*, No. C07960105, 1998 NASD Discip. LEXIS 47, at *13 (NASD NAC Oct. 22, 1998) ("A customer's prior transactions ... are not relevant in a suitability determination ...."); *Dale E. Frey*, Initial Decisions Rel. No. 221, 2003 SEC LEXIS 306, at *41 (Feb. 5, 2003) ("[P]ast transactions should not be used to assume that the current trade is appropriate."). *But see Jack H. Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *13 n.20 (Feb. 10, 2003) (allowing a respondent to introduce some information about a customer's account at another broker-dealer during the relevant period on the issue of the customer's net worth).

decisions about the trading at issue and thus whether the broker had *de facto* control over the account. The GunnAllen records also were relevant as impeachment tools. Customer SM's answers to some questions during cross-examination could be viewed as inconsistent with information contained in those records.

Medeck's Initial Counsel first tried to obtain the records through a Rule 9252 request, which essentially asked FINRA to issue a Rule 8210 request requiring GunnAllen, among others, to provide account opening documentation and monthly account statements for Customer SM's account during and immediately after the period when he had an account at Continental. The Hearing Officer denied the motion because Medeck filed it three days after the deadline for filing such motions, failed to show that the information was relevant, and failed to show that he could not obtain the information by other means.

Medeck's Initial Counsel, who also represented GunnAllen on some matters, then obtained the GunnAllen records directly from GunnAllen, which the Hearing Panel below found to be inappropriate. The Hearing Panel prohibited Medeck from using the records in any manner, including as part of his expert's report or for impeachment purposes.

In light of the materiality of the GunnAllen records to the issues in this case regarding Customer SM's credibility and whether Medeck had *de facto* control over the account, as well as the seriousness of the charges and possible sanctions, we hold that the Hearing Panel erred in rejecting Medeck's original Rule 9252 request for the GunnAllen records. Medeck is permitted on remand to use the GunnAllen records that are currently part of the supplemental record. He may use them both (1) on the issue of whether he had *de facto* control over the account because Customer SM was "unable to evaluate" Medeck's recommendations and was unable "to exercise independent judgment" and (2) to impeach Customer SM's testimony.

The Hearing Panel below also excluded audiotapes of telephone conversations between Rhee and Customer SM during which Customer SM allegedly told Rhee that he recently sold a company and expected to use the proceeds to cover his short position but that it was taking longer than he anticipated to get the proceeds. (Customer SM had denied during cross-examination that he ever made such a claim.) Customer SM lives in California, a state requiring that all parties to a conversation be aware that it is being recorded. *See* California Penal Code Section 632;[38] *see also Kearney v. Salomon Smith Barney, Inc.*, 45 Cal. Rptr. 3d 730 (2006); *Feldman v. Allstate Ins. Co.*, 322 F.3d 660, 667 (9th Cir. 2003). Rhee indicated that he did not independently inform Customer SM that he was taping the conversations. If there was no other disclosure to Customer SM that his conversations were being or could be recorded, then the Hearing Panel properly excluded the audiotapes and any transcripts thereof. Rhee's testimony regarding the conversation, however, is admissible regardless of whether Customer SM knew of the recording.

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[38] California Penal Code Section 632 makes it illegal to record a telephone conversation without the consent of all parties. The statute also provides that, except to prove a violation, no evidence obtained in violation of Section 632 "shall be admissible in any judicial, administrative, legislative, or other proceeding."

E. Claim of Prejudice Regarding Enforcement's Use of Continental Settlement

On several occasions during the hearing below, Enforcement intimated that Medeck's activity was similar to Continental's misconduct that ultimately led to its expulsion from the securities industry via a settlement. However, Medeck was not a party to that settlement and Enforcement's complaint in this case did not accuse him of having engaged in any improper scheme with Continental. On appeal, Medeck argued that Enforcement's references to Continental and the settlement during his hearing were prejudicial to him and constituted reversible error. We disagree. Although some of Enforcement's comments regarding Continental may have been ill advised, others were simply used to explain the origins of Enforcement's investigation of Medeck and none of them appear to have inappropriately influenced the Hearing Panel or otherwise risen to a level of impropriety requiring reversal.

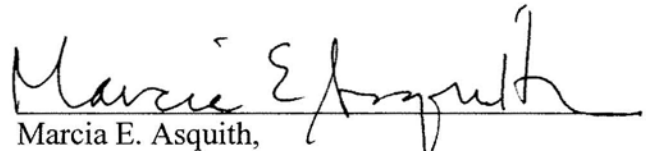
V. Sanctions

Imposition of appropriate sanctions, if any, will depend on the resolution of a number of issues discussed herein. We note, however, that the Hearing Panel's finding of customer harm of $41,493, on which the Hearing Panel relied in imposing restitution, appears problematic. Our reading of the record indicates that Customer SM's entire account loss (including $14,227 in commissions and $637 in margin interest charges) was only $26,629.

VI. Conclusion

In sum, we reverse the Hearing Panel's decision and remand this matter to the Office of Hearing Officers for proceedings consistent with the discussion above.[39]

On behalf of the National Adjudicatory Council,



Marcia E. Asquith,
Senior Vice President and Corporate Secretary

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[39] We have considered and reject without discussion all other arguments advanced by the parties.