

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 03-81

June 12, 2003

THOMAS MICHAEL MONAHAN
REGISTERED REPRESENTATIVE

* * *

Made misstatements to customers regarding the terms of certificates of deposit; effected trades of certificates of deposit for customers at prices away from the market; effected unauthorized trades in customers' accounts and failed to act in the best interests of customers – Censure, one year suspension and \$25,000 fine.

Appearances:

For the Division of Enforcement
Steven J. Brostoff, Esq.
Howard A. Grinsberg, Esq.
Robert J. Meyers, Esq.

For the Respondent
Martin P. Russo, Esq.

* * *

An Exchange Hearing Panel conducted a hearing on charges contained in a Charge Memorandum issued by the Exchange's Division of Enforcement against Thomas Michael Monahan, a registered representative formerly employed by Legg Mason Wood Walker, Incorporated (the "Firm"), a member organization. Mr. Monahan was charged with having:

- I. Engaged in conduct inconsistent with just and equitable principles of trade by, on one or more occasions, making a misstatement to a customer of his member organization employer regarding the terms of certificates of deposit.
- II. Engaged in conduct inconsistent with just and equitable principles of trade by, on one or more occasions, effecting trades of certificates of deposit for customers of his member firm employer at prices away from the market.
- III. Engaged in conduct inconsistent with just and equitable principles of trade by, on one or more occasions, effecting an unauthorized trade in a customer's account.
- IV. Engaged in conduct inconsistent with just and equitable principles of trade by, on one or more occasions, failing to act in the best interests of customers of his member firm employer.
- V. Caused violations of Exchange Rule 440 and SEC Rules 17a-3 and 17a-4 by causing his member organization employer to reflect inaccurate purchase and sale prices of certificates of deposit on its books and records.

Through his counsel, Mr. Monahan submitted an Answer to the Charge Memorandum by which he admitted some of the allegations contained in the Charge Memorandum and denied others. The Answer also denied the charges and asserted affirmative defenses.

After a hearing at which Mr. Monahan, among others, appeared and testified, the Hearing Panel found as follows:

Background and Jurisdiction

1. Monahan was born on March 8, 1960 and was employed by the Firm from 1986 to October 1999.
2. The Exchange received an Amended Form U-5, dated November 16, 1999 from the Firm stating that Monahan, who had voluntarily resigned on October 15, 1999, had been the subject of several customer complaints that he had misrepresented the terms of bank issued Certificates of Deposits (“CDs”) that the customers had purchased.
3. By letter dated July 13, 2000, which he received, the Exchange notified Monahan that it was investigating the customer’s allegations.

Terms of the CDs

4. In or about late 1997 through October 1999, on Monahan’s recommendation, numerous customers purchased “callable,” “step-down” CDs issued through the Firm by nationally chartered banks.
5. The CDs were generally long-term, usually 15 or 20 years in length. The CDs initially paid interest for the first year or two (the “Initial Period”) at a rate above the average rate for shorter-term bank issued CDs. Thereafter, the CDs would generate interest income at a fixed “step-down” rate, ranging from approximately one to two percentage points less than the initial rate, for the duration of the term of the CD.
6. During the Initial Period, the CDs were not callable by either party. Beginning at the conclusion of the Initial Period, and continuing at regular intervals thereafter, the CDs were callable at the option of the issuer bank only.
7. If called, the face value of the CD would be returned to the holder of the CD, plus any accrued interest. If the CD was not called, the holder of the CD had to wait until maturity to receive back the full face value unless a “flower provision” was triggered.
8. Under the “flower provision,” the CD could be redeemed prior to maturity for full face value if the holder died or became incapacitated.
9. There was a limited secondary market for the CDs. If the holder of the CD wanted to liquidate the CD at any time prior to maturity, the only means to do so was to sell it in the secondary market at the prevailing market price.

10. The CDs were carried on the customers' statements at par even though they had a lower value in an illiquid market.

Misstatements to Customers

11. Monahan told customers that they would have the right to redeem the CDs at par at certain times prior to maturity.
12. Even though the CDs had lengthy maturities, Monahan assured the customers that they could enjoy the initial higher rate and then, if they desired, sell the CDs at par.
13. Monahan told customers that the customers could utilize the "flower provision" by selling the CD at full face value to an account that could take advantage of the "flower provision."

14. In a letter to one customer, Monahan stated:

If the certificates are not called Purchaser will have the right, but not the obligation to redeem the Certificate for full payment of principal within 45-60 days of the annual anniversary date. This means that after one year full payment will be made assuming Purchaser provides reasonable notice.

And later in the letter, it states:

The Certificates of Deposit purchased will have a flower provision which enables the account holder in the event of death or disability to receive full payment of principal and interest. In the event that the Certificate of Deposit needs to be sold, they can, under certain conditions be sold to an account where the flower provision would come into effect, thus shortening the maturity of the Certificate of Deposit for the seller, and having, in all probability, a short term maturity for the buyer. Certificates of Deposit purchased through brokerages have been liquid investments. The flower provision is an added tool to help insure the full payment of principal and interest on a short term basis. For example, if after one year the Certificate is transferred or sold to an account where the flower provision would come into effect, the Certificate would have a one year maturity, if transferred or sold after two years, it would have a two year maturity, and so on.

15. Monahan claimed that the letter was approved by his employer.
16. The customers who testified before the Hearing Panel maintained that Monahan assured them that they would have the ability to sell the CDs at par.
17. The customers also testified that they were interested in one year or short term CDs.

Trading Away from the Market

18. In 1999, Monahan decided to change employers. His new employer told him that it did not make a market in “step-down” CDs.
19. Monahan wanted to get the customer with short term aspirations out of the CDs before he changed employers.
20. In his efforts to extract these customers from the CDs, Monahan arranged for the sale of some CDs without customer authorization. One customer was even out of the country when the sale took place.
21. Monahan then arranged for other of his customers to purchase the CDs at par (“the cross trades”). (See EHPD 03-82 Tony Gannacone, III)
22. The CDs in the cross trades had initial interest rates of between 7 and 9% with “step-down” rates of between 6 and 7%. The maturity dates varied from 2018 to 2019. Despite the variations, the cross-trades all took place at the same price, par.
23. The Firm calculated corrected trade prices, based on the prevailing market prices and then current interest rates, of between \$82 and \$96 per \$100.
24. The purchasers of the CDs were entitled to acquire the CDs at fair market prices which were below par.
25. In arranging for the cross trades, Monahan effected trades at prices away from the market.
26. In allowing the purchasers of the CDs to pay par, an above market price, for the CDs, Monahan failed to act in the best interest of his customers.

Alleged Books and Records Violation

27. In its Charge Memorandum, the Division of Enforcement alleged that the cross trades of the CDs created records that contained purchase and sale prices that were greater than the actual secondary market prices of the CDs.
28. At the hearing, the parties agreed that the records accurately reflected the prices at which the transactions occurred.

DISCUSSION AND DECISION

A registered representative is the securities industry’s first line of defense in assuring that customers are dealt with in accordance with just and equitable principles of trade. The registered representative has a professional, legal and ethical obligation to ensure that customers are dealt with fairly and honestly. The Hearing Panel believed that Monahan breached these duties and responsibilities to his customers.

The Hearing Panel found that Monahan sold long term “step-down” certificates of deposit to customers who were interested in and seeking short term investments. The Hearing Panel also found that Monahan erroneously conveyed to these customers the understanding that they had the ability and the right to sell these certificates at full face value (par) at certain times, regardless of the actual redemption provisions contained in the instruments.

Monahan was aided in conveying this impression to customers by the fact that the Firm carried the certificates of deposit at par on the customers’ monthly statements. This may well have contributed to the customers’ understanding of their right to redeem at par. However, Monahan’s efforts to ascribe his misconduct to the Firm is misdirected. Monahan is primarily responsible for dealing with the customers, conveying accurate information to them and ensuring that they are treated fairly.

To Monahan’s credit, he did arrange for the customers who appeared before the Hearing Panel to redeem their certificates at par, but in doing so he effected some unauthorized trades. Many customers first realized that their CDs had been sold when they received a check for the proceeds from the Firm.

Monahan also arranged for the sale of the CDs to other customers at prices away from the market and thus failed to act in the best interests of those customers (the “purchasers”). The Hearing Panel realizes that other market makers may have calculated different market prices from those calculated by the Firm, but par was not a reasonable price. The purchasers were entitled to receive the best efforts of their registered representative to obtain a best market price for their acquisitions. Monahan failed these customers

With respect to Charge V, the Hearing Panel found that the books and records of Monahan’s employer accurately reflected the prices at which the cross transactions occurred even though the prices were not the prevailing market prices. Monahan had an obligation to ensure that his employer’s records accurately reflected the transaction prices. He fulfilled that obligation.

Accordingly, the, Hearing Panel, by unanimous vote, found Monahan guilty of Charges I, II, III and IV and, by unanimous vote, found Monahan not guilty of Charge V.

PENALTY

The Hearing Panel, by unanimous vote, determined that Mr. Monahan be censured, suspended from membership, allied membership, approved person status, and from employment or association in any capacity with any member or member organization for a period of one year and fined \$25,000.

For the Hearing Panel

Edward W. Morris, Jr.
Chief Hearing Officer