

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 03-110

June 10, 2003

JOHN SALVATORE SPINELLI

FORMER REGISTERED REPRESENTATIVE

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Violated Exchange Rule 342 by failing to reasonably supervise certain business activities subject to his control; caused a violation of Exchange Rule 405 by failing to use due diligence to learn essential facts relative to every customer – Consent to censure, eighteen month supervisory bar, and requirement to retake appropriate supervisory examinations.

Appearances:

For the Division of Enforcement
Susan F. Axelrod Esq.
Kenneth R. Bozza, Esq.

For the Respondent
Julian Friedman, Esq.

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and John Salvatore Spinelli, a former registered representative and Administrative Manager with Merrill Lynch, Pierce, Fenner & Smith, Inc. (the "Firm"). Without admitting or denying guilt, Mr. Spinelli consents to findings by the Hearing Panel that he:

- I. Violated Exchange Rule 342 in that he failed to reasonably supervise certain employees and/or business activities subject to his control.
- II. Caused a violation of Exchange Rule 405 in that he failed to use due diligence to learn the essential facts relative to every customer.

For the sole purpose of settling this disciplinary proceeding, the Division of Enforcement and Mr. Spinelli stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. John Salvatore Spinelli ("Spinelli") was born on January 29, 1948. He began his employment in the securities industry in 1968 with the Firm. While employed at the Firm, he held various positions, which included Administrative Manager of the Winter Park, Florida office (the "Winter Park office") from September 7, 1999 until March 19, 2001. On August 3, 2001, Spinelli voluntarily resigned from the Firm. He is currently employed on a part-time basis doing clerical work at another member firm.

2. In or about August 2001, Enforcement received a Uniform Termination Notice for Securities Industry Registration (“Form U-5”) reporting that registered representative (“RR”) Tania M. Torruella (“Torruella”)¹, whose sales activities Spinelli supervised in his capacity as Administrative Manager, was terminated by the Firm on July 5, 2001. The Form U-5 reported that the Firm received numerous customer complaints concerning Torruella’s activities as an RR and that an internal review revealed that Torruella violated industry standards of conduct and Firm policies, including those regarding the exercise of discretion and suitability.²
3. The Firm has since reported to the Exchange approximately 200 customer complaints against Torruella involving in excess of 550 separate accounts alleging, among other things, failure to follow instructions, unsuitable trading, exercising discretion without written authorization and creating and issuing unapproved correspondence to customers. To date, the Firm has settled virtually all of those claims and has paid approximately \$28 million.
4. The Exchange notified Spinelli of its investigation by letter dated October 15, 2001, which he received.³

Overview

5. While serving as the Administrative Manager of the Winter Park office of the Firm during the period from September 7, 1999 through March 19, 2001, Spinelli violated Exchange Rule 342 in that he failed to reasonably supervise Torruella. More specifically, Spinelli failed to reasonably supervise certain of Torruella’s activities involving: the process of obtaining new account documents; reviews of the activity in the accounts of Torruella’s customers in order to ascertain the propriety of such activity and determine the appropriate action to be taken; the exercise of discretion in accounts of Torruella’s customers; and the determination of whether investments made in Torruella’s customers’ accounts were suitable. Spinelli also caused a violation of Exchange Rule 405 in that he failed to use due diligence to learn the essential facts relative to certain of Torruella’s customers.

Spinelli’s Duties and Responsibilities

6. As Administrative Manager of the Winter Park office, Spinelli was delegated various duties by the Senior Resident Vice President (“RVP”) and later Managing Director of

¹ Torruella joined the Firm as an RR on August 27, 1999. She began working in the Winter Park office, where she remained throughout her tenure at the Firm, six business days prior to Spinelli becoming the Administrative Manager for that office.

² On June 13, 2002, an Exchange Hearing Panel found Torruella guilty of violating Exchange Rule 477 in that she failed to comply with written requests by the Exchange that she appear and give on-the-record testimony concerning matters that occurred prior to the termination of her status as an employee of a member firm. (See Hearing Panel Decision 02-121). The Hearing Panel imposed the penalty of a censure and bar until she complied, which was to become permanent if she did not comply within three months. Since she did not comply within the three-month period, Torruella is permanently barred from the securities industry

³ In addition to action against Spinelli, this investigation has resulted in separate disciplinary actions against other respondents.

the office, Ernest James Hinderliter (“Hinderliter”). These duties included, among other things, the following: oversight of new accounts, which included supervising the process of obtaining Retail Account Profiles (“RAPs”) that were required for each account opened at the Firm; monthly active account reviews, which included a review of Merrill Lynch Unlimited Advantage (“MLUA”) Accounts⁴ Exceeding Threshold Reports (“ETRs”) and later the Firm’s computerized Account Review Monitoring and Online Reporting (“ARMOR”) MLUA reports; daily review of Compliance 1028 Reports reflecting all of the transactions that were executed on the previous day by each RR; and dealing with customer sales practice complaints.

Failure to Supervise

Torruella’s Hiring and Standing at the Firm

7. When Torruella came to the Firm after leaving her position with another securities firm, she brought to the Firm between \$70 to \$80 million in assets from her prior employer along with approximately 200 customers. As such, Torruella was given a significant compensation package, which included a substantial up-front bonus, various options and stock, and arranged to bring over to the Firm her two assistants.
8. During her tenure at the Firm, Torruella was a substantial producer for the Firm. In 2000, her ranking by production was 1 out of 28 in the Winter Park Office and 830 out of 16,121 retail brokers nationwide (i.e., ranked in top 5% of Firm).

Overview of Customer Complaints

9. The allegations contained in most of the approximately 200 customer complaints the Firm received from former customers of Torruella include the following: that Torruella asked them for and they gave her discretion in their accounts without written authorization being obtained from them; and that neither Torruella nor her assistants contacted them before each solicited trade or transaction was made in their accounts – this is despite the fact that all the accounts were asset-based non-discretionary (i.e., MLUA) accounts. Furthermore, many of her customers allege they did not have extensive investment experience and relied upon Torruella to make diversified investments in their accounts which were safe and secure. Instead, for many of her customers, Torruella followed investment strategies that ultimately resulted in investing significant portions of their assets at the Firm in technology, telecommunications or internet stocks.
10. The positions in technology, telecommunications and internet stocks purchased by Torruella’s customers as a result of her investment strategies were unsuitable for many customers in view of the concentrated nature of such positions and the customers’ investment objectives, risk tolerance and financial resources. Moreover, unbeknownst to Torruella’s managers and the Firm, when customers made contact with Torruella, she gave them assurances that the decline suffered in their accounts as

⁴ An asset-based non-discretionary brokerage service introduced by the Firm in July 1999.

a result of these investments would improve over time if the customers continued to hold their positions.

11. In addition, in August 2000, a customer told Spinelli, the Winter Park office's Service Manager, and later Hinderliter, among other things, that Torruella was not calling her as frequently as she desired and was also not calling her before some transactions were effected in her account.

New Account Documents – Retail Account Profiles

12. While Torruella was employed at the Firm, written Firm policy required that a RAP be completed for every account opened at the Firm prior to any trading taking place in the account. The RAP, which listed a customer's investment objective and risk tolerance, and contained information about a customer's background, employment, income, and investment experience, was to be prepared by the RR in consultation with the customer. As noted above, it was Spinelli's responsibility to supervise the process of obtaining a RAP for all accounts, and then to review the RAP to learn the essential facts relative to every customer and determine, among other things, suitability. Once this was done, Spinelli was then supposed to countersign the RAP, which was then to be filed in the Winter Park office. Accounts that were missing the RAP were required to be restricted from trading if a RAP was not obtained either within 2 days of the assignment of an account number or prior to the first trade having been made, whichever was earlier.
13. Each branch office, which included Winter Park, maintained a New Account Log Book ("Log Book") for monitoring the receipt of the RAP. Included in this book was the name of the customer and account number for every account opened at the Firm, the identity of the RR who was responsible for the particular account, and a column where the date of the receipt of the RAP for each account was to be entered. Firm policy required that the Log Book be reviewed by branch management on a weekly basis to make sure that new account documentation was complete. This policy also required that management "diligently follow up on determining the disposition of and collection of new account forms for all account numbers that have been assigned." Managers were also required to evidence their review by initialing each page of the Log Book "after he/she has verified that approved new account forms have been received for each account number assigned." While Spinelli was responsible for reviewing and initialing each page of the Log Book, he did not begin doing so until at least three months after he began working at Winter Park.
14. When Spinelli began to review the Winter Park Log Book, which took place in late December 1999 or January 2000, it showed that approximately 200 of Torruella customer accounts, more than one-half of which were opened after Spinelli began working in the Winter Park office, were missing a RAP. Despite this discovery,

Spinelli failed to make sure that a RAP was on file for all accounts.⁵ Further, trading in these accounts was never restricted as required by Firm policy.

15. Spinelli's failure to ascertain during his tenure as Administrative Manager that a continuing problem existed with Torruella obtaining and completing a RAP for each of her customers' accounts, and his failure to monitor and make sure that such documents were on file for all customer accounts, prevented him from learning at an early stage of problems concerning Torruella's handling of her accounts. Further, he caused a violation of the "know your customer" rule (*i.e.*, Exchange Rule 405) in that he never reviewed RAPs for the accounts of the customers that were missing them to determine suitability.

Active Account Reviews/Exception Reports

16. Firm procedures required Spinelli to conduct monthly reviews of accounts that appeared on the Firm's active account reviews/exception reports (*i.e.*, ETRs and/or ARMOR MLUA reports) as a result of the activity and losses sustained in the accounts, and to consider contacting customers as part of such reviews based on criteria promulgated by the Firm. Despite the fact that many of Torruella's customers had accounts that appeared at various times on these reports, no Torruella customer was ever contacted by Spinelli as part of an active account review.
17. Following his review of the July 2000 ETR, which contained the accounts of eight Torruella customers, a two-page letter for each of these customers, dated September 22, 2000, was drafted and signed by Spinelli. However, Spinelli decided not to mail these letters because Torruella convinced him that the information they contained was outdated. Instead, Spinelli decided he would continue to monitor the accounts and wait until they appeared on a successive month's ETR before the customer was contacted.
18. The aforementioned letters contained important information that should have been transmitted to customers, asked them to review their investment activity in light of their investment objectives and tolerance for risk, and invited them to contact branch management to correct any inaccurate information or discuss any aspect of their account. The chance of such contact occurring was increased by the fact that the letters made certain erroneous statements – Spinelli erroneously advised each customer that the risk tolerance they had for their account was "aggressive" rather than moderate, and that the transactions executed in the account were based on the customers' own investment ideas when in fact each trade was marked on the Firm's 1028 reports as being solicited.
19. Spinelli's decision to agree to Torruella's request that he not mail these letters was in contravention of Firm policy in light of the activity in these accounts. Because he did not mail these letters, the eight customers were not prompted to contact him. Spinelli

⁵ Moreover, in April 2001, it was discovered by Spinelli's successor as Administrative Manager that 215 of Torruella's accounts were missing a RAP.

- failed to follow Firm procedures that were designed to detect whether Torruella was making unsuitable investments for these customers and was exercising discretion, among other things. Furthermore, based upon a customer also telling Spinelli and other managers in August 2000 that Torruella was not calling her before some transactions were effected in her account, Spinelli knew or should have known that Torruella was taking discretion in at least one customer account well prior to his September 22nd letters. Despite this, other than speaking with Hinderliter about the customer's complaint, Spinelli took no corrective action with respect to the customer nor did he conduct any investigation to learn whether this situation existed with other customers.
20. Spinelli also failed to continue to properly monitor the aforementioned customers' accounts that appeared on the July 2000 ETR, since five of these customers and their accounts appeared on subsequent ETRs. Moreover, in the September and October 2000 ETRs, Spinelli made notations next to the names of customers who were the subject of his unsent September 22nd letters which indicated that Spinelli had contacted these customers. These notations were inaccurate.
 21. In addition, because starting in November and December 2000 and continuing into January and February 2001, Spinelli purportedly became overwhelmed with his job and was getting behind in his work, he failed to review the November 2000 ETR and the December 2000 ARMOR MLUA Reports, which replaced the ETR and became available online starting in January 2001. Although Spinelli spoke with others at the Firm, which included Hinderliter, to ask for help, Spinelli never told anyone at the Firm that he was unable to do his job or review the reports for these months.
 22. Because Spinelli failed to review the December 2000 ARMOR MLUA report, he did not discover that 292 accounts belonging to Torruella's customers appeared therein. Further, he also did not discover the accounts of four of the customers to whom he was going to send his September 22nd letters also appeared on this report. Based upon the level of trading activity and losses sustained in many of these accounts, Spinelli was required to contact these customers – the only exception to this Firm policy would be if a bona fide reason, which was documented by Spinelli, existed for not making such contact. By not doing so, Spinelli failed to follow Firm procedures that were designed to detect whether unsuitable investments were being made and whether discretion was being exercised by Torruella in these customer accounts.

Torruella's Exercise of Discretion

23. One of the duties delegated to Spinelli by Hinderliter was the daily review of the Firm's Compliance 1028 reports that reflected all of the transactions that were executed in the Winter Park office on the previous day by each RR, which included Torruella. During certain periods and on various dates these reports reflected that a significant number of transactions for a large number of customers were made by

- Torruella, and virtually all of these transactions were noted to have been solicited.⁶ Given that all of Torruella's customers were enrolled in the Firm's non-discretionary Unlimited Advantage program, Spinelli not only should have suspected that it was not possible for Torruella to have contacted and spoken with all of such customers before each of these trades, he should have also inquired further as to whether Torruella was doing so. Thus, Spinelli failed to follow Firm procedures that were designed to detect whether Torruella was exercising discretion in these accounts.
24. At no time during his tenure as Administrative Manager in the Winter Park office did Spinelli's review of a Compliance 1028 report ever cause him to conclude that discretion was being taken by Torruella.
 25. However, prior to a compliance visit he made to the Winter Park office in June 2000, the Firm's Senior Compliance Officer suspected Torruella was exercising discretion based upon his review of three weeks worth of Compliance 1028 reports and his observation of a significant number of transactions for a large number of customers that appeared on such reports. The Senior Compliance Officer addressed his concerns with Spinelli prior to his compliance visit and both Spinelli and Hinderliter during such visit. Notwithstanding this, the Senior Compliance Officer only conducted a meeting attended by them, Torruella and Torruella's two assistants. After the Senior Compliance Officer was told during the meeting that both Torruella and one of her assistants were calling clients, and after the Senior Compliance Officer reminded Torruella that customers must be contacted one or two days in advance of an order entry and that they be advised of the particulars of the transaction that would be taking place, nothing further was done to verify that Torruella was not exercising discretion. Moreover, no further action was taken by any Firm employee, including reaching out to customers to confirm with them that they knew what they were buying or selling prior to transactions being effected in their accounts.
 26. For all the reasons set forth above, Spinelli violated Exchange Rule 342 by failing in all respects to reasonably supervise Torruella and detect that she was exercising discretion and making unsuitable investments in her customers' accounts. Moreover, he also caused a violation of Exchange Rule 405 in that he failed to use due diligence to learn the essential facts relative to certain of Torruella's customers.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Mr. Spinelli guilty as set forth above by unanimous vote.

⁶ For example, the 1028 report for April 4, 2000 reflected that Torruella effected a total of 1,306 transactions for at least 113 different customers, and on April 5, 2000, 498 transactions were effected for 105 customers; the 1028 report for October 25, 2000 reflected that 203 transactions were effected for 107 customers, and on October 26, 2000, 1,040 transactions were effected for 122 customers.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Mr. Spinelli of a censure; an eighteen month supervisory bar; and a requirement that he retake and pass the appropriate supervisory examinations prior to being employed as a supervisor or acting in a supervisory capacity.

For the Hearing Panel

Milton M. Stein
Hearing Officer