

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 03-111

June 10, 2003

ERNEST JAMES HINDERLITER

FORMER REGISTERED REPRESENTATIVE

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Violated Exchange Rule 342 by failing to reasonably supervise certain employees 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, five 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
Lee S. Richards, 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 Ernest James Hinderliter, a former registered representative and Senior Resident Vice President with Merrill Lynch, Pierce, Fenner & Smith, Inc. (the "Firm"). Without admitting or denying guilt, Mr. Hinderliter 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. Hinderliter stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. Ernest James Hinderliter ("Hinderliter") was born on March 1, 1952. He entered the securities industry in 1981 as a trainee with the Firm. Throughout his career, he remained employed with the Firm in various positions, which included Senior Resident Vice President (later titled Managing Director) of the Winter Park Florida Complex of the Firm, consisting of six offices and approximately 140 employees, from approximately November 1994 through August 2001. From approximately the

beginning of 1999 until August 17, 2001 Hinderliter was the Managing Director of the Winter Park, Florida office (the “Winter Park office”). He thereafter voluntarily retired from the Firm, which became effective on March 8, 2002, and he is not currently employed in the securities industry.

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 Hinderliter supervised in his capacity as Managing Director, 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 Hinderliter of its investigation by letter dated October 15, 2001, which he received.³

Overview

5. While serving as the Senior RVP and later Managing Director of the Winter Park office of the Firm during the period from approximately the beginning of 1999 until August 17, 2001, Hinderliter violated Exchange Rule 342 in that he failed to reasonably supervise Torruella as well as his Administrative Manager, John Spinelli (“Spinelli”). More specifically, Hinderliter failed to make sure that the responsibilities he delegated to Spinelli were carried out in a reasonable fashion. Accordingly, Hinderliter failed to 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

¹ Torruella, who joined the Firm as an RR on August 27, 1999, worked in the Winter Park office for approximately twenty-two months during Hinderliter’s tenure at the Firm.

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 Hinderliter, this investigation has resulted in separate disciplinary actions against other respondents.

made in Torruella's customers' accounts were suitable. Hinderliter 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.

Hinderliter's Duties and Responsibilities

6. Hinderliter, a non-producing Managing Director, was responsible for the overall running of the Winter Park, Florida Complex, which included the Winter Park office, and the supervision of its registered and non-registered employees. This included, among other things, training, oversight of compliance matters, and the oversight of the office's sales and sales support functions. Hinderliter was therefore responsible for supervision of Torruella, as well as Spinelli,⁴ his Administrative Manager.
7. Consistent with Firm policy and as permitted by Exchange Rules, Hinderliter delegated to Spinelli, among other things, the following duties: 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") Accounts – an asset-based non-discretionary brokerage service introduced by the Firm in July 1999 – 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.
8. On a quarterly basis, Hinderliter was also required to submit to his supervisor, a District Director of the Firm, a document entitled "Resident Vice President Quarterly Supervisory Attestation." This report attested to the fact that Hinderliter or his "qualified delegate" (*i.e.*, Spinelli) had conducted reviews of, among other things, active accounts, new account forms, and Compliance 1028 reports, and that there were "no serious regulatory or Firm policy violations that have not been reported to the District office or the Compliance Department."

Failure to Supervise

Torruella's Hiring and Standing at the Firm

9. 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 previous 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.

⁴ Spinelli, an experienced veteran at the Firm, was employed as the Administrative Manager of the Winter Park office from September 7, 1999 until March 19, 2001.

10. Even before she began working at the Firm, Hinderliter knew that Torruella wanted to enroll her customer accounts in the Firm's Personal Investment Advisory ("PIA") Program, a fee-based investment advisory service in which the RR functions as a discretionary portfolio manager. Yet, even after Torruella placed all of her clients in the Firm's non-discretionary MLUA accounts, Hinderliter failed to take all reasonable steps to make sure that Torruella did not exercise discretion in those accounts and never made her aware she could not do so. Further, Hinderliter never directed Spinelli to monitor Torruella's customer accounts to make sure discretion was not being taken.
11. 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

12. 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 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 significant portions of their assets at the Firm being invested in technology, telecommunications or internet stocks.
13. 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 a result of these investments would improve over time if the customers continued to hold their positions.
14. 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 (“RAP”)

15. 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, Hinderliter delegated to Spinelli the responsibility to supervise the process of obtaining a RAP for all accounts, and then to review the RAP for 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.
16. 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.”
17. While Spinelli was responsible for reviewing and initialing each page of the book, he did not begin doing so until at least three months after he began working at Winter Park as Hinderliter failed to take sufficient steps to make sure he was performing these duties. Once Spinelli began reviewing the Log Book, he observed 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. Unbeknownst to Hinderliter, however, Spinelli took no remedial action, and RAPs were not obtained for most of these accounts, nor was trading restricted as required by Firm policy. Moreover, Hinderliter did not adequately monitor the Log Book to determine if a RAP had been obtained for all of Torruella’s customers or, as Firm policy required, to see whether Spinelli had properly reviewed and initialed each page of the book.
18. Because Hinderliter failed to reasonably supervise Spinelli to make sure that RAPs were on file for all of Torruella’s customers’ accounts, in April 2001, it was discovered by Spinelli’s successor as Administrative Manager that 215 of Torruella’s accounts were missing a RAP. Moreover, Hinderliter did not know that there were any problems in obtaining RAPs or that a significant amount of RAPs were missing

for Torruella's customers until after Spinelli's departure from the Winter Park office. In addition, Hinderliter never noticed that virtually all of Torruella's clients had a risk tolerance of "moderate" listed on their RAPs. Further, he did not notice until Winter or Spring 2001 that almost all of Torruella's customers had portfolios made up almost exclusively of technology and telecommunication stocks. Hinderliter acknowledged that for many customers such a portfolio was not suitable.

19. Hinderliter's failure to ascertain during Spinelli's 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 properly supervise and monitor Spinelli to 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. Hinderliter's failures with respect to the obtaining of RAPs further caused a violation of the "know your customer" rule (*i.e.*, Exchange Rule 405), in that the Firm was prevented from learning the essential facts relative to every customer.

Active Account Reviews/Exception Reports

20. Another of the duties Hinderliter delegated to Spinelli was to conduct, according to Firm procedures, 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.
21. Despite the fact that many of Torruella's customers had accounts that appeared at various times on these reports, because of Hinderliter's failure to adequately monitor Spinelli's work he was unaware that Spinelli failed to ever contact any Torruella customer as part of an active account review. Further, he never contacted any customers himself as part of an active account review and never directed that Spinelli do so.
22. Because many of these accounts had sustained considerable losses, Firm policy required that these customers be contacted – the only exception to this Firm policy would be if a bona fide reason, which was required to be documented, existed for not making such contact. In addition to notifying customers of the substantial volume of trades and of the significant depreciation that had taken place in their accounts year to date, the customers should have also been asked to review their investment activity in light of their investment objectives and tolerance for risk, and should have been told to contact Spinelli if they would like to discuss any aspect of their account.
23. Hinderliter also did not detect that Spinelli failed to continue to monitor accounts that appeared on ETRs and on ARMOR MLUA Reports, and that he made false notations on certain ETRs indicating that some customers were indeed contacted. Furthermore, Hinderliter never learned that on September 22, 2000 Spinelli had drafted letters to eight of Torruella's customers whose accounts had appeared on the July 2000 ETR

but then decided not to mail them after he showed them to Torruella who convinced him that since the information was outdated, *i.e.*, it was based on information from two months prior, he should continue to monitor the accounts and wait until they appear on a successive months ETR before the customer was contacted. Spinelli then failed to continue to monitor these accounts.

24. The failure to contact customers whose accounts appeared on ETRs or ARMOR MLUA Reports was in violation of Firm procedures that were designed to detect whether unsuitable investments were being made and whether discretion was being exercised by Torruella, among other things. Furthermore, based upon a customer telling Hinderliter in August of 2000 that Torruella was not calling her before some transactions were effected in her account, Hinderliter knew or should have known that Torruella was taking discretion in at least one customer account. Despite this, he did not take sufficient action with respect to the customer's complaint, nor did he conduct, or direct that anyone else conduct, any investigation to learn whether this situation existed with other customers. Further, in violation of Firm policy Hinderliter failed to notify the Firm's Compliance Department of the receipt of the customer's complaint.
25. In addition, despite being told by Spinelli that he was behind in his work and needed assistance, Hinderliter never discovered that Spinelli completely failed to review the November 2000 ETR and the December 2000 ARMOR MLUA Report. As such, neither Spinelli nor Hinderliter discovered that 292 accounts belonging to Torruella's customers appeared on the December 2000 ARMOR MLUA Report, and neither contacted those customers as part of active account reviews.
26. Hinderliter signed and submitted the Firm's Quarterly Supervisory Attestation report to his supervisor based upon his reliance on Spinelli's representations that he was properly and timely doing reviews of ETRs and later the ARMOR MLUA reports. However, Hinderliter failed to take reasonable steps to determine that Spinelli was actually properly carrying out these duties.

Spinelli's Request for Assistance

27. In or about the Fall of 2000, Spinelli asked Hinderliter for help and advised him that he was busy and getting behind in his work, without going into specifics. Hinderliter did not more fully investigate why Spinelli initially made a request for assistance or what Spinelli meant by his statement that he was getting behind or in what way he was failing to fulfill his responsibilities.
28. Following his conversation with Spinelli, Hinderliter spoke to at least one of his superiors about getting some help for Spinelli. Although Hinderliter claims that some help was provided to Spinelli, the Firm has no records to support this.
29. It was incumbent upon Hinderliter to fully investigate why his Administrative Manager would make such a request, something that he failed to do. Moreover, while

Hinderliter should have been aware even before Spinelli's request that he was not carrying out his duties with regard to obtaining RAPs and performing active account reviews, once Spinelli asked him for help a spot-checking of Spinelli's work should have led Hinderliter to uncover that the duties and responsibilities he delegated to Spinelli were not being carried out in a reasonable manner in accordance with Exchange Rules and federal securities laws.

Torruella's Exercise of Discretion

30. Another 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.⁵
31. Given that all of Torruella's customers were enrolled in the Firm's non-discretionary Unlimited Advantage accounts, both Spinelli and Hinderliter 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, they both should have also inquired further as to whether Torruella was doing so. Thus, it should have been detected that Torruella was exercising discretion in these accounts.
32. At no time during his tenure as Managing Director in the Winter Park office did Hinderliter's review of a Compliance 1028 report ever prompt him to take action to ascertain whether discretion was being taken by Torruella.
33. However, prior to a compliance visit he made to the Winter Park office in June 2000, a 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 large 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

⁵ 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.

- 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.
34. For all the reasons set forth above, Hinderliter violated Exchange Rule 342 and caused a violation of Exchange Rule 405. While Hinderliter was not expected to have personally performed all of the work he delegated to Spinelli (*i.e.*, oversight of new account documents and review of Compliance 1028 and active account/exception reports), at the minimum he should have regularly spot-checked Spinelli's work. This is particularly true in light of his signing the Firm's Quarterly Supervisor Attestation Report, which attested to the fact that these types of reviews were properly completed. Accordingly, Hinderliter's failure to properly supervise Torruella and Spinelli permitted Torruella's violative conduct – *i.e.*, exercising discretion and making unsuitable investments in her customers' accounts – to continue and remain undetected until the Firm began receiving a substantial number of complaints from Torruella's customers.

DECISION

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

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Mr. Hinderliter of a censure; a five month supervisory bar; and a requirement that he retake and pass 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