N E W Y O R K S T O C K E X C H A N G E L L C

<u>NYSE HEARING BOARD DECISION 07-156</u> **December 14, 2007**
JASON N. SLEZAK
REGISTERED REPRESENTATIVE

Caused a violation of NYSE Rule 342.16 by failing to get prior approval before sending a letter soliciting a potential customer's market timing business – Censure.

<u>NYSE HEARING BOARD DECISION 07-157</u>
X
FORMER ASSISTANT BRANCH OFFICE MANAGER

Charged with having: violated NYSE Rule 405(1) and (2) by failing to use due diligence to learn essential facts about customer and failing to diligently supervise registered representative's handling of his customer's accounts; violated NYSE Rule 342 by failing to appropriately supervise and control business activity of registered representative and his customer to ensure that they were in compliance with NYSE Rules and firm's internal policies; caused violation of NYSE Rule 440 and Rules 17a-3 and 17a-4 under Securities Exchange Act of 1934 by approving customer's fictitious new account documents, thereby causing books and records maintained by firm to be inaccurate – Not guilty.

<u>NYSE HEARING BOARD DECISION 07-158</u>
Y
COMPLIANCE MANAGER

Charged with having: violated NYSE Rule 405(1) and (2) by failing to use due diligence to learn essential facts about customer and failing to diligently supervise registered representative's handling of his customer's accounts; violated NYSE Rule 342 by failing to appropriately supervise and control business activity of registered representative and his customer to ensure that they were in compliance with NYSE Rules and firm's internal policies; caused violation of NYSE Rule 440 and Rules 17a-3 and 17a-4 under Securities Exchange Act of 1934 by approving customer's fictitious new account documents, thereby causing books and records maintained by firm to be inaccurate – Not guilty.

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Appearances:

For the Division of Enforcement
Susan Light, Esq.
Julie Han Broderick, Esq.
Margaret M. Tolan, Esq.
Jill G. Fieldstein, Esq.

For Respondent Slezak
Kenneth F. Berg, Esq.

For Respondents X and Y
Pete S. Michaels, Esq.
Deborah G. Evans, Esq.

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A Hearing Panel on behalf of the New York Stock Exchange LLC ("NYSE") considered a Charge Memorandum issued by NYSE Regulation, Inc.'s Division of Enforcement ("Enforcement") against Jason M. Slezak, a registered representative formerly with the member organization now known as Wachovia Securities, LLC ("Wachovia" or the "Firm"), X, a former assistant branch officer with the Firm, and Y, a compliance officer with the Firm. Slezak was charged with having:

I. Caused a violation of NYSE Rule 405(1) in that he failed to use due diligence to learn the essential facts about his customer.

II. Caused a violation of NYSE Rule 440 and Rules 17a-3 and 17a-4 under the Securities and Exchange Act of 1934 (the "Exchange Act") by assisting his customer in opening fictitious accounts, thereby causing the books and records maintained by the Firm to be inaccurate.

III. Caused a violation of NYSE Rule 342.16 by failing to get prior approval before sending a letter soliciting a potential customer's market timing business.

IV. Engaged in conduct inconsistent with just and equitable principles of trade by assisting a customer in opening one or more fictitious trust accounts, purchasing numerous variable annuity contracts with which the customer improperly timed the market, and opening fee-based accounts in which the customer timed the market by investing in international mutual funds.

X and Y were each charged with having:

I. Violated NYSE Rule 405(1) and (2) by failing to use due diligence to learn the essential facts about Slezak's customer and failing to supervise diligently Slezak's handling of his customer's accounts.

II. Violated NYSE Rule 342 by failing to appropriately supervise and control Slezak's and his customer's business activity to ensure that they were in compliance with NYSE Rules and the Firm's internal policies.

III. Caused a violation of NYSE Rule 440 and Exchange Act Rules 17a-3 and 17a-4 by approving a customer's fictitious new account documents, thereby causing the books and records maintained by the Firm to be inaccurate.

Slezak filed his Answer on April 17, 2006; X and Y filed their joint Answer on April 24, 2006. In their respective Answers, Respondents denied most of the allegations and each of the respective Charges issued against them.

Based on the pleadings, evidence and argument presented at the hearing, the Hearing Panel made the following findings:

Background and Jurisdiction

Jason N. Slezak

1. Jason N. Slezak was born in [redacted]. He entered the securities industry in November 1993, working in the institutional equity research sales department of Member Firm A.[1] In February 1995, Slezak began working in the institutional equity research sales department of a different member firm, which is no longer a member of the NYSE. In March 1997, Slezak joined the institutional equity research sales department of Member Firm B. In March 1999, Slezak joined Member Firm C in its retail sales department. In March 2000, Slezak joined First Union Securities, Inc. ("First Union") as a financial advisor in the retail sales department's Professional Development Training Program. In June 2002, First Union merged with and became Wachovia Securities, Inc., which then became the Firm in June 2003. During the relevant time period of April through October 2002, Slezak worked in Wachovia's West Wacker Branch in Chicago (the "Wacker Branch") and was promoted from a financial advisor trainee to a vice-president in investments. In November 2002, Slezak joined the retail sales department of a non-member firm, where he continues to work.

2. Enforcement received a Uniform Notice of Termination ("Form U-5") from Wachovia on October 28, 2002. Wachovia reported in the Form U-5 that Slezak was terminated for failing to follow Firm policy regarding the opening of new accounts.

3. By letter dated, March 14, 2003, which Slezak received, Enforcement notified Slezak of its investigation into this matter. Slezak, represented by counsel, subsequently testified before Enforcement.

Respondent X

[1] In 1981, Slezak worked for approximately one year as a runner on the floor of the Chicago Board Options Exchange (the "Options Exchange") and as trainee for one of the Options Exchange's member firms.

4. X was born in May 1951. He entered the securities industry in 1981, working as a trainee for Member Firm D. In 1999, X joined Everen Securities, Inc. ("Everen") as a financial advisor. In October 1999, Everen merged with and became First Union, which then became Wachovia. In December 1991, X obtained his Series 8 registration, which qualified him to act as a securities sales supervisor. During the relevant time period of April through October 2002, X acted as the assistant branch officer manager of the Wacker Branch. X continues to work for Wachovia as a financial advisor.

5. During on-the-record testimony on March 3 and 4, 2004, in which he was represented by counsel, X was notified that he could be subject to formal or informal disciplinary action if Enforcement determined that he had failed to carry out his supervisory responsibilities or otherwise violated applicable NYSE rules or securities regulations.

Respondent Y

6. Y was born in February 1967. He entered the securities industry in 1989, working as a broker in the Chicago branch of a non-member firm. In 1992, Y obtained his Series 24 registration and became the branch manager's assistant, then the branch administrative manager, and finally the branch compliance manager. In 1998, Y joined Everen as the assistant branch administrative manager for the Wacker Branch. In February 1998, he obtained his Series 8 registration, which qualified him to act as a securities sales supervisor. Y then became a branch administrative manager for Everen, overseeing the sales assistants. When Everen merged with First Union, Y's title changed to branch compliance manager, which it remained through First Union's merger with Wachovia. At all relevant times, Y was the compliance manager for Wachovia's Wacker Branch. He continues to work for Wachovia as a compliance manager in Indiana.

7. During on-the-record testimony on March 2 and 3, 2004, in which he was represented by counsel, Y was notified that he could be subject to formal or informal disciplinary action if Enforcement determined that he had failed to carry out his supervisory responsibilities or otherwise violated applicable NYSE rules or securities regulations.

Alleged Violative Conduct

Overview

8. From April to September 2002, Slezak's customer ("Customer") opened 30 trust accounts with Wachovia that he used in an effort to conceal market-timing activity from variable annuity issuers and the managers of international mutual funds.[2]

[2] The U.S. Securities and Exchange Commission (the "SEC") has defined "market timing" as "(a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing." Invesco. Funds Group, Inc., Exchange Act Release No. 50,506, 83 S.E.C. Docket 2872, 2004 WL 2270297, at *1 (Oct. 8, 2004). Variable annuities hold mutual funds as their underlying investment and, therefore, may serve as a vehicle to time the market. The SEC has held that market timing, "while not illegal per se, can harm other mutual

Customer purchased approximately $40 million worth of variable annuities for 17 of the trust accounts and used those annuities to market time in the annuities' sub-accounts. In 13 other fee-based accounts, Customer made approximately $3 million worth of investments in international mutual funds using a market-timing investment strategy.

9. Enforcement alleged that Customer's activities "raised numerous red flags pointing directly to the fictitious nature of [his] accounts and to his improper market timing activities." Charge Memo. ¶ 9. Enforcement further alleged that Slezak, X, and Y either failed to recognize, or ignored these "red flags" and, in so doing, "enabled [Customer] to use his Wachovia accounts to carry out his market timing investment strategy." Id.

Customer Begins Doing Business With Wachovia

10. Some time in or prior to February 2002, Slezak received a number of customer-related documents from a broker who was leaving the Firm. The documents contained contact information for former customers of the Firm. The departing broker told Slezak that he should feel free to contact these former customers to solicit their business. Customer was among the individuals identified in these documents.

11. Slezak contacted Customer in early February 2002. At that time, Slezak was a financial advisor trainee who had made approximately $53,000 in 2000 and $70,000 in 2001.

12. Customer ran a hedge fund (the "Limited Partnership") and was the principal of a money management company (the "Corporation"). Customer agreed to do business with Slezak in or around April 2002.

Customer Opens Several Trust Accounts

13. Between April and July 2002, Customer opened 18 trust accounts with Wachovia, each of which name a Customer-controlled entity, like the Corporation, as trustee for the benefit of 18 different family trusts. One of the family trusts was the Customer Family Trust, and the 17 others were represented to be trusts set up on behalf of 17 wealthy mining families from Utah. The first three accounts that Customer opened,

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fund shareholders because it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, or disrupt the management of the mutual fund's investment portfolio and can cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer." Id., at *2. For example, substantial redemptions by a market timer may force a portfolio manager to liquidate certain fund holdings under unfavorable circumstances, which would impact all mutual fund shareholders negatively. As a result, mutual fund companies typically monitor activity in their funds' shares and impose quantitative or qualitative restrictions on excessive trading. Because many mutual funds monitor for excessive trading by broker and customer account numbers, the use of multiple account numbers affords an account holder a degree of anonymity that can be used to deceive mutual fund companies into accepting trades that would otherwise have been rejected.

for example, were opened in the name of the Corporation as trustee for three different family trusts: the L Family Trust, the M Family Trust, and the N Family Trust.

14. Wachovia required different treatment for accounts opened by trustees and those managed by outside money managers, that is, money managers who, like Customer, were not affiliated with Wachovia. Specifically, when opening an account for an outside money manager, the Firm requires the following documentation:

    (a) an executed Power of Attorney signed by the customer naming the outside money manager;

    (b) the most recent copy of the advisory agreement between the money manager and the customer; and

    (c) written evidence that the money manager is currently registered in the state of the customer's residence.

15. Wachovia's policies further provide that relationships with such non-affiliated money managers "require heightened awareness" by the branch office manager; the latter is also required to "be aware of all arrangements between the [financial advisor] and the Money Manager."

16. For a trust account, on the other hand, Wachovia required only that the trustee provide the Firm with a Trustee Certification of Investment Powers (the "Trustee Certification"), which certifies that the trustee will adhere to the provisions of the underlying trust. The Trustee Certification provides the trustee with the authority to sign all new account documents and make investment decisions for the trust.

17. For each of the 18 trust accounts that Customer opened between April and July 2002, he presented Slezak with a Trustee Certification. For 14 of the 18 accounts, Customer also gave Slezak a corporate resolution from the relevant Customer-controlled entity, granting Customer the power to act on behalf of the trustee of the relevant family trust.

18. Customer opened each of his accounts as a trust account, even though (1) Customer had represented to Slezak that Customer was a money manager and (2) that representation had been conveyed to both X and Y. At no time did Customer provide Wachovia with any powers of attorney, or advisory agreements, or any evidence that he was registered as a money manager in Utah.

Customer's New Account Documents

19. Pursuant to the powers granted by the Trustee Certifications, Customer filled out and signed the new account documents (the "NADs"). For items such as income, net worth, net liquid assets, investment objectives, risk tolerance, and knowledge and experience, Customer provided information about himself. Thus, other than the account name and the tax identification number, the NADs for each of the 18 family

trust accounts were almost identical.

20. None of the NADs, Trustee Certifications, corporate resolutions, or any other information Customer provided to Slezak, who then passed the information on to X or Y, revealed any identifying information about any of the trust families other than the families' last names. The address given for each account was 303 East Wacker Drive in Chicago, which was the Corporation's address.

21. Customer also provided Slezak with the trust agreements for all of the family trusts for which he opened accounts at Wachovia, even though Wachovia's policies did not require that a customer submit a trust agreement to open a trust account.

22. The trust agreements provided that a Customer-controlled entity would be the only beneficiary of each of the family trusts. None of the trust agreements names the relevant family trust as a party, nor are the family trusts mentioned in any the agreements, other than on the cover page of the agreements. Instead, in the case of each agreement, the signing parties are two Customer-controlled entities.

23. Y approved the NADs for all of the family trust accounts opened between April and July, except for the Customer Family Trust account, which X approved.

Customer's Variable Annuities Purchases

24. Within a week of opening the L, M, and N Family Trust accounts on April 24, 2002, Customer began purchasing variable annuity contracts on behalf of the family trusts. From May through September 2002, Customer purchased approximately $40,000,000 worth of annuities on behalf of 17 of the 18 family trusts. From these annuity investments, Slezak and Wachovia earned their respective shares of approximately $600,000 in commissions.

25. To effect the purchase of an annuity contract, Customer would fax a transmittal letter to Slezak authorizing money to be wired from the designated bank into the money market account associated with the relevant family trust account and authorizing the money to be used to purchase one or more annuities. In every case, the designated bank was a specific Chicago Bank or a specific Utah bank.

26. The transmittal letters also identified the person to be named as the annuitant—that is, the person who receives the benefits of an annuity if the contract is annuitized—on the relevant variable annuity contract. In the various transmittal letters, Customer named himself, his family members, and his employees as annuitants on the contracts purchased on behalf of the various trusts.

The Wacker Branch Supervisors Laud Slezak

27. As a result of Customer's annuity investments, Slezak's production figures rose dramatically. From May through July 2002, Slezak was either the top earner or among the top earners in the Wacker Branch. At the end of May 2002, Slezak was

recognized as a top earner, having earned for himself and the Wacker Branch approximately $69,000 in commissions that month, with approximately $64,000 of that total resulting from Customer's annuity purchases.

28. On June 14, 2002, GF, the then Branch Office Manager, sent the sales department a memo noting that while it was an "average production day" for the Wacker Branch, it was "a major day for … Jason 'The Star' Slezak …." Enforcement Exhibit ("Enf. Ex.") 169. In another memo, also dated June 14, 2002, GF stated: "Even in tough times determination and hard work has its rewards. Jason Slezak has brought in 50% of office production for the month of [June] and is still in the trainee program." Id.

29. On July 16, 2002, GF announced Slezak's promotion to the title of "Vice President in Investments." On July 29, 2002, X sent a memo informing the sales department that:

> [It was] [a]nother massive day for Jason "Rock Star" Slezak, who single-handedly accounted for over half the office's production on Friday. Rumor has it that Jason will be on the cover of next month's Rolling Stone.

Enf. Ex. 169.

30. In total, Customer purchased approximately $15,450,000 in annuity products in July, earning Slezak and the Wacker Branch their part of approximately $210,000 in commissions.

Concern About Customer's Investment Activities

A. Customer Begins Surrendering Annuity Contracts

31. Debits began showing up on Slezak's commission account in May 2002, just a few weeks after Customer purchased the first of his annuity contracts. The first debit appeared on May 20, 2002, after Customer surrendered three annuity contracts he had purchased on May 3, 2002. The surrender resulted in a $21,000 chargeback to Wachovia—the amount of the entire commission that the annuity company had paid to Wachovia on May 3rd.

32. Slezak's commission account was again debited in the amount of $18,800 on July 8, 2002, after Customer surrendered two more annuity contracts. On July 17, 2002, Slezak's account was again debited in the amount of $29,200, when Customer cancelled three more annuity contracts.

33. All of Slezak's commissions and chargebacks appeared on his daily commission run and the daily trade blotter. Y was the person responsible for reviewing the daily commission runs and could see when debits showed up on Slezak's account. X had access to the computer screen that showed the commission totals by broker, and was aware that, at times, huge negative items appeared on Slezak's commission runs.

B. Communications about Excessive Trading

34. In each of the accounts, within days of a variable annuity purchase, Customer began trading mutual funds in the variable annuity sub-accounts. However, this trading was not as readily visible to X or Y as the trading in the more transparent Pilot Plus accounts which were opened later that year (see para. 57 below).

35. Between June 4 and July 2, 2002, Customer invested $4,850,000 through his Wachovia accounts in five Annuity Company P variable annuity contracts on behalf of five different family trusts. Annuity Company P paid Slezak and Wachovia $48,500 in commissions for these transactions.

36. On July 12, 2002, the vice president of operations for Annuity Company P sent Slezak a letter stating that Annuity Company P had noticed excessive trading in the variable annuities purchased for three of the family trust accounts. The letter advised Slezak that "we intend to actively monitor the activities in accounts with excessive trading and reserve the right to cancel or reject any trade…." Enf. Ex. 110B. However, at that time, Annuity Company P did not bar Customer from making further trades. Subsequently, as reflected in the transaction confirmations that Slezak received from Annuity Company P, on August 9, 2002, Customer surrendered each of the Annuity Company P contracts purchased for the three relevant family trusts.

37. Between June 25 and July 31, 2002, through his Wachovia accounts, Customer invested $6,397,000 in nine Annuity Company T variable annuity contracts on behalf of nine different family trusts. Annuity Company T paid Slezak and Wachovia $70,778 in commissions for these transactions.

38. On August 1, 2002, the vice president of Annuity Company T's Annuity Services wrote separate letters to eight of the nine family trusts for whom Customer had purchased Annuity Company T annuities. Annuity Company T copied Slezak on each of the letters and at least one of the produced copies indicates that Y reviewed the incoming correspondence. The vice president informed the various family trusts that a recent review of the transfer activity in each of the entity's accounts "showed that you have engaged in excessive trading activity." The letter went on to state:

> Excessive transfers can disrupt the management of our underlying variable options and increase transaction costs. … Pursuant to the terms of your [Annuity Company T] Variable contract, [Annuity Company T] has the right to restrict the number of transfers you can make to one transfer per six-month period and effective August 5, 2002, [Annuity Company T] is hereby exercising this right.

Enf. Ex. 110F.

C. The Active Account Reports

39. Y detected active trading in Customer's accounts as early as May 31, 2002, when Wachovia's computer monitoring systems generated active account reports for the L, M, and N Family Trust accounts. Y filled out and signed the account review worksheets attached to the bottom of the active account reports indicating that the accounts were opened and money was invested during May. Since Y had already reviewed the variable annuity investments in these accounts when the investments were originally made, he indicated on the active account reports that no further review was needed.

40. Active account reports were again generated for the L, M, and N Family Trust accounts on June 30, 2002, along with reports for the five other family trust accounts that had been opened up to that date. Slezak completed the account review worksheets attached to the bottom of each of these reports and dated the completed worksheets July 15, 2002.

41. Under "client information" for each of the eight worksheets, Slezak indicated that the client was a 41-year old investor, with a net worth of $7.5 million and a liquid net worth of $7 million. Moreover, Slezak responded, "yes" to the worksheet question: "Is this information consistent with that shown on applicable new account forms…?"

D. Slezak's July Meetings with his Supervisors

42. In mid-July 2002, after Slezak had filled out the active account worksheets for June, Y began to have concerns about the accounts. First, he noted that the bulk of Slezak's commissions came from one customer; second, this was the second month in which Slezak's accounts were showing up on the active account reports; third, the reports showed relatively large amounts invested in 8 different trust accounts all associated with the same contact person (an employee of Customer), who was not on the Firm's approved money-manager list. Y expressed his concerns to GF, who told him to talk to Slezak.

43. Y talked with Slezak on two consecutive days. Y noted that Customer's accounts were not coded correctly to be money-managed accounts and that the Firm did not have on file the requisite documentation for managed accounts, despite the fact that Slezak had represented in the past that Customer was a money manager. Slezak told Y that Customer was the trustee for trusts set up by wealthy Utah families and suggested that Y contact Customer directly to ask any questions that Y had. Y called Customer in the presence of Slezak, and Customer stated that he was a trustee for wealthy Utah families, not a money manager. Y was satisfied with Customer's answers and was convinced that the accounts had been adequately documented and properly coded as trust accounts, and he relayed this to GF.

44. Around the same time, X also began to feel uneasy about Slezak's book of business and wanted Slezak's accounts to be watched carefully.

45. In mid-July 2002, X, GF and Y met with Slezak so that the branch supervisors could better understand the large block of business that Customer was bringing to the branch. The supervisors were satisfied with the explanations that they received from Slezak. Nevertheless, out of Slezak's presence, GF told Y to continue investigating anything that seemed unusual about Customer's accounts and investment activity.

E. Customer Market Times in His Own Family Trust Account

46. On June 24, 2002, Customer opened the Customer Family Trust account. The NADs for the Customer Family Trust were virtually identical to the NADs for the family trust accounts that Customer had previously opened.

47. Customer applied to have the Customer Family Trust account participate in Wachovia's "Pilot Plus," or fee-based, account program. On July 10, 2002, GF approved Customer's Pilot Plus application. On that day, Customer also received the authority to trade online in the Customer Family Trust account.

48. Unlike the previous family trust accounts, Customer used the Customer Family Trust account to invest in international mutual funds. With his online trading authority, Customer invested in the mutual funds directly with Wachovia's trading desk.

49. The Customer Family Trust account statements indicate that Customer began to trade in and out of the international mutual funds. On July 17, 2002, Customer invested $10,000 in an international mutual fund, which he sold on July 22nd. On the same day, Customer invested $10,000 in another international mutual fund, which he sold on July 23rd. On July 23rd, he then invested $5,000 in each of five other international mutual funds. He then sold his interest in those five funds on July 24th. On July 30th, he invested $5,000 in each of ten more international mutual funds, which he sold on July 31st.

The Branch Supervisors Meet with Slezak about Market Timing

50. On August 12, 2002, Y read an article in Barron's entitled "Gaming International Funds." The article explained how arbitrageurs were targeting international mutual funds to "capture the overnight price changes between the U.S. and foreign markets" by taking advantage of "stale" mutual fund prices. Enf. Ex. 188. The article triggered a thought in Y's mind about the trading activity in Customer's sub-accounts; Y expressed his concern to GF and X that Customer might be market timing, and the supervisors decided to convene a meeting with Slezak.

51. The next day, on August 13, 2002, GF, X, and Y met with Slezak to discuss possible market timing in Customer's variable annuity sub-accounts (the "August 13 Meeting"). The supervisors explained to Slezak that "market timing" was becoming a common term for a prohibited form of international mutual fund arbitrage. Slezak represented that he did not know anything about this concept of market timing; he also stated that he did not know that Customer had been using his annuities to time

the market. At the meeting, X showed Slezak a printout from the Limited Partnership website in which Customer openly touted his success with market timing. Under the heading "Fund Investment Strategy," the printout stated:

> Originally intended as an attractive and safe alternative to cash equivalent funds, the mutual fund timing strategy has demonstrated exceptional returns with low volatility. [The Limited Partnership's] goal of achieving superior risk-adjusted returns is accomplished by exploiting the differences between overseas and U.S. equity markets, including time zone differences, pricing inefficiencies and performance correlations.

Enf. Ex. 164.

52. During the meeting, the Wacker Branch supervisors told Slezak that the Firm would not countenance market timing activity. GF told Slezak to stop doing business with Customer to the extent that Customer was going to use his investments to engage in market timing. Both X and Y believed that Slezak understood what he had been told and that they could rely on him not to allow Customer to market time going forward.

Customer Purchases Additional Variable Annuities in August and September

53. GF was out of the office from August 14 until September 9, 2002 for health reasons.

54. Y, still concerned that Customer was engaged in improper activity, scheduled a meeting with him in early September, but Customer cancelled that meeting. The meeting was rescheduled for September 24, 2002. See Enf. Ex. 180 at 4.

55. Despite GF's admonition at the August 13 Meeting, Slezak continued to purchase annuities for Customer. From August 13 through September 12, 2002, Customer purchased approximately $644,000 in new variable annuity contracts and added on approximately $6,000,000 in additional funds to already-existing variable annuity contracts. From these transactions, Slezak and the Wacker Branch earned their share of approximately $137,000 in commissions.

Customer Opens Twelve More Wachovia Accounts

56. Slezak met with X in mid- to late-August and told him that Customer wanted to trade directly in mutual funds through a broker-dealer. X gave him instructions on how to open Pilot Plus accounts.

57. X believed that opening the Pilot Plus accounts would be a positive step because all of Customer's trading activity—including any potential market timing—would be readily visible on a same- or next-day basis through the daily trade blotter. Moreover, all trading in the Pilot Plus accounts was monitored by the Firm's Consulting Services Group ("CSG"), a department dedicated to servicing Pilot Plus accounts.

Finally, while the revenue generated from annuity purchases in the Pilot Plus accounts would be expected to be smaller than the commissions that Wachovia would receive if those purchases were made in a traditional account, the revenue would be more secure because there would be no possibility of chargebacks.

58. In early September 2002, Customer opened 12 Wachovia Pilot Plus accounts. X approved the five accounts that Customer opened on September 5, 2002, and Y approved the other seven accounts, which were opened on September 9, 2002.

59. In each of his Pilot Plus accounts, Customer invested in various international mutual funds, sold the investments one to three days later, then invested in other international mutual funds. He would then repeat the pattern.

Customer's Market Timing Activity is Discovered

60. On September 18, 2002, Slezak received an e-mail from Wachovia's clearinghouse stating that three of Customer's Pilot Plus accounts had been banned from trading in all H mutual funds. On September 13, 2002, Customer had invested a total of $633,000 in H International mutual funds for the benefit of the G, H, and R Family Trusts, and then sold those interests on September 17th.

61. On September 20, 2002, Slezak received an e-mail from Wachovia's clearinghouse stating that another of Customer's Pilot Plus accounts had been banned from trading in all AC mutual funds. On September 18, 2002, Customer had invested $250,000 in an AC international mutual fund for the benefit of the C Associates LLC account and then sold that interest on September 19.

62. On September 23, 2002, Slezak received an e-mail from a CSG supervisor stating that Customer appeared to be market timing mutual funds in the five Pilot Plus accounts that he had opened on September 5, 2002. The e-mail continued:

> The firm has a no market timing policy and … does not allow for this trade activity in our Pilot Plus program. I have attached the firm's policy …. I am going to have to terminate the Pilot [Plus] agreement on the … listed accounts.

Enf. Ex. 124.

63. Also on September 23, 2002, Customer invested a total of $419,000 in two different international mutual funds on behalf of the K and P Family Trusts, which were among Customer's remaining Pilot Plus accounts. He sold those interests on September 24, 2005.

64. On September 24, 2002, Customer invested $211,000 in an international mutual fund on behalf of the R Family Trust, which was another remaining Pilot Plus account.

65. On September 25, 2002, Customer invested approximately $1.2 million in various international mutual funds on behalf of the G, H, I, J, P, and R Family Trusts, all of which were among the remaining Pilot Plus accounts.

66. On September 26, 2002, Slezak, GF, and X received another e-mail from Wachovia's CSG department, stating that Customer's eight remaining Pilot Plus accounts (including the Customer Family Trust account opened in July 2002) were being terminated, and that no further orders should be accepted for these accounts.

67. On that same day, GF sent Customer a letter informing him that the Firm was exercising its option to terminate all of Customer's accounts.

The Wacker Branch Investigates Customer's Accounts

68. As Wachovia's CSG department began to terminate Customer's Pilot Plus accounts, X began reviewing all of the accounts that Customer had opened. X noticed that some of the account names lined-up in alphabetical order; using a spreadsheet, he listed and sorted all of the names and realized that, as a group, they were virtually alphabetical. It was only at this time that X and Y understood that the Customer accounts had most likely been set up using the names of fictitious families to conceal the accounts' true ownership.

69. In or around October 2002, Wachovia searched Slezak's computer and found a letter, dated June 6, 2002, in which Slezak solicited the principal of a capital management firm for his market timing business. Slezak's letter states:

> My purpose for contacting you is to let you know that I have developed some close business ties to firms that utilize Annuities for the purpose of Market Timing Investing. . . . I am the largest producer of annuities in the [Wachovia] Chicago office, with close ties to several of the largest annuity companies.

Enf. Ex. 170.

70. Slezak did not seek prior approval before sending the letter because he knew it contained exaggerations about his experience and would not have been approved.

71. Wachovia terminated Slezak's employment on October 15, 2002.

DECISION

I. Charges Against Slezak

The Hearing Panel unanimously found Slezak guilty of Charge III and not guilty of Charges I, II, and IV.

Charge I

NYSE Rule 405, often referred to as the "Know-Your-Customer Rule," provides as follows:

> Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to …(1) [u]se due diligence to learn the essential facts relative to every customer … [and] (2) … [s]upervise diligently all accounts handled by registered representatives of the organization.[3]

One of the purposes of the Know-Your-Customer Rule is to protect customers from inappropriate activity by a broker and to better equip a customer in maintaining an action against a broker if inappropriate conduct has occurred. See, e.g., Order Instituting Proceedings to Determine Whether Proposed Changes to Rule 405 Should Be Disapproved, Exchange Act Release No. 14,143, 1977 WL 190097, at *2 ("SEC Order on Rule 405"). For example, the Know-Your-Customer Rule ensures that a broker has the necessary information to conduct an appropriate suitability analysis for each transaction executed on behalf of a customer and that the brokerage activity has been duly authorized by the customer. See Margaret J. Shimp, Decision 89-91 (NYSE Hearing Board Sept. 15, 1989) (finding that registered representative violated NYSE Rule 405 where she opened escrow account without obtaining escrow agreement or other documentation sufficient to determine account's legal or beneficial ownership, person or persons entitled to give instructions for such account, or person whose investment objectives should be reflected on firm's new account form).

However, the Know-Your-Customer Rule also serves the purpose of rooting out fraud or other criminal activity, such as money laundering or the financing of terrorism, by requiring broker-dealers to verify the identity of their customers. See Customer Identification for Broker Dealers, Exchange Act Release No. 47,752, 80 S.E.C. Docket 206, 2003 WL 1982171, at *25 (Apr. 29, 2003) (noting overlap between due diligence requirements of NYSE Rule 405 and anti-money laundering and anti-terrorist customer identification program requirements under Section 326 of USA PATRIOT Act); see also SEC Order on Rule 405, at *2 (suggesting that NYSE Rule 405 is "designed to prevent fraudulent or manipulative acts or practices"). In this case, the alleged failures to comply with NYSE Rule 405 had nothing to do with any issue of suitability, but rather, turned on whether Slezak (and his supervisors, see infra) conducted sufficient due diligence to root out what is now known to have been the fraudulent practices of Customer. In other words, did Slezak do enough to determine whether his customer was engaged in legitimate business?

In addressing that question in the context of trust accounts, however, a preliminary question arises: namely, who is the "customer" for purposes of complying with NYSE Rule 405? Several legal and natural persons may be involved in any given trust account. Any one or all of them could conceivably be viewed as the "customer," including the beneficiaries of the trust, the trustee, and—in the case of a corporate trustee, as in this matter—the individual or individuals authorized to act on behalf of such corporate trustee.

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[3] Slezak was only charged with having violated paragraph (1) of NYSE Rule 405.

To resolve this ambiguity, the Panel looked to interpretive guidance issued in 2003 by what was then known as the NASD (now FINRA). In a document entitled "Comparison of the AML Customer Identification Rule and the SEC's Books & Records Customer Account Records Rule," which was admitted in evidence as Slezak Exhibit 16 (the "NASD Guidance"), the NASD offered interpretive comments concerning 31 C.F.R. 103.122, the Customer Identification Final Rule implementing Section 326 of the USA PATRIOT Act, as compared with Rule 17a-3(a)(17) under the Exchange Act. See also NASD Notice to Members 03-34 (June 2003) (explaining requirements of Section 326 of USA PATRIOT Act). In relevant part, the NASD Guidance states under the heading "Trust Accounts" that:

> A broker/dealer is not required to look through a trust or similar account to its beneficiaries, and is required only to verify the identity of the named accountholder.

NASD Guidance (Slezak Ex. 16) at 2. Moreover, the SEC has noted that:

> [W]here [an] account is owned by the trustees of [a] trust or a trust that is a legal entity separate from the holders of its beneficial interests (which may be natural persons), the account record requirement [set forth in Rule 17a-3(17) under the Securities and Exchange Act of 1934] does not apply.

Interpretive Release: Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 47,910, 80 S.E.C. Docket 823, 2003 WL 21205149, at *2 (May 22, 2003) (the "2003 SEC Interpretive Release") (Slezak Ex. 14 at 2).

Slezak offered expert testimony on the issue of what was required under NYSE Rule 405 and SEC Rule 17a-3. The expert opined that, in the case of an account owned by a corporate trustee, based on the interpretive guidance set forth above, the "customer" for purposes of NYSE Rule 405 would be the individual designated by the corporate trustee to act on its behalf. He testified that:

> [I]n the case of a corporate trustee, I would be concerned with -- I would feel, No. 1, that they could rely upon the trustee, in this case [Customer], as a representative of [the corporate trustee] or they could depend upon him to give us whatever information we would need on the trust. And I would be looking for -- primarily looking for information that the trustee, [the corporate trustee or Customer], did, in fact, exist; did have a legal address; did have a telephone number; did have a tax ID number; did have a place of business; did, in fact, operate an ongoing business.

Tr. at 1367-68.

Enforcement alleged that Slezak knowingly, or with reckless disregard for the truth, ignored the truth about Customer and his accounts. In reality, however, the evidence showed that Slezak did make diligent efforts to know his customer and confirm that he was engaged in a legitimate business. First, Slezak visited Customer at the latter's office, which was within walking distance of the Wacker Branch, and verified that Customer and his corporation had a physical place of business, that the corporation had numerous employees, and that it was engaged in what appeared to be a legitimate, on-going money-management business. Slezak also confirmed that Customer's corporation had a working telephone number. Slezak testified that he even contacted a former mentor of his from a previous company, who had gone on to open his own investment firm; according to Slezak, his former mentor said that he knew Customer, having met him "at a couple of … banking conferences," that Customer was "a reputable person" and "a bright guy" who had "attended Harvard" and was "active in the community." Tr. at 1174-75.

Customer also created an elaborate paper trail that suggested the family trusts on whose behalf he was apparently working were legitimate and that he had received proper authorization to so act. First, he actually created the required trust agreements to bring into existence each of the trusts at issue, and all of those trust agreements were admitted in evidence. The testimony established that Customer also obtained a genuine tax identification number from the federal government for each of those trusts.[4] Moreover, the record established that Customer executed proper trustee certifications, as required by Firm policy, stating that Customer was authorized to purchase and sell securities on behalf of the various trusts for whom the accounts were being opened. For most, if not all, of the 30 accounts, he also caused the relevant corporate trustee to execute a resolution that confirmed Customer's authority to act on behalf of such trust. All of these documents were duly submitted to Slezak in connection with the opening of the accounts, and many of these documents were not even required by Firm policy, further buttressing the documents' legitimacy and Customer's apparent good faith.

Based on this evidence, the Hearing Panel concluded that Slezak fulfilled his duties under NYSE Rule 405 and, we therefore found him not guilty of Charge I.

Charge II

Enforcement contended that the accounts opened by Slezak were "fictitious" because the families on whose behalf the trusts were supposedly created did not exist. Therefore, Enforcement argued, the NADs—which are meant to reflect information required under Rule 17a-3(a)(17), including net worth, investment objectives, and investment experience—were inaccurate. Consequently, Enforcement urged the Panel to find a violation of Exchange Act Rules 17a-3 and 17a-4 and NYSE Rule 440.

Enforcement did not specify which sub-paragraph or sub-paragraphs of Rule 17a-3 it believed were applicable to this matter. After reviewing the entire Rule, the only provision that appeared

[4] The exhibits admitted in evidence included a formal notice of assignment of a federal "Employer Identification Number" (or "EIN") from the Internal Revenue Service for 8 of the 30 accounts; the exhibits also included SS-4 application forms for an EIN for 2 additional accounts. Moreover, the account form for each of the family trusts included a "Tax ID" number, and a senior compliance officer of the Firm testified that the Tax ID number for each of the trusts was screened by the Firm and came back valid. See Tr. at 196-97.

relevant to the Panel was Rule 17a-3(a)(17)(i)(A), which governs account records and which provides in relevant part:

> Every member of a national securities exchange … shall make and keep current … [a]n account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives.

However, as set forth above, the 2003 SEC Interpretive Release makes clear that the Rule 17a-3(a)(17) account record requirement does not apply in the case of an account "owned by the trustees of the trust or a trust that is a legal entity separate from the holders of its beneficial interests (which may be natural persons)…." 2003 SEC Release (Slezak Ex. 14) at 2-3. All of the accounts in this matter were opened on behalf of a corporate trustee that had a separate legal existence from the beneficiaries on whose behalf the trusts were created. Thus, Rule 17a-3(a)(17) did not apply, and it is irrelevant that Slezak may have filled out the NADs, at least in part, using Customer's own information with regard to such items as net worth and investment objectives. As a matter of law, Slezak cannot have caused a violation of a rule that did not apply.[5]

In light of the above, the Panel concluded that there was no violation of Rule 17a-3 or 17a-4 or NYSE Rule 440.[6] Accordingly, we found Slezak not guilty of Charge II.

<u>Charge III</u>

Slezak admitted during his testimony that he sent a letter, dated June 6, 2002, soliciting a potential customer's business without first obtaining supervisory approval of that letter. A printout of a Microsoft Word version of the letter, which was admitted in evidence, <u>see</u> Enf. Ex.

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[5] Even if the account record requirement were deemed to apply, Enforcement failed to prove that the information contained in the NADs was actually inaccurate. On the contrary, as set forth above, the trusts actually existed, each one had a proper tax identification number, and the required authorizations were executed to allow Customer to enter trades on behalf of the trusts. Moreover, as explained above, given his status as trustee, Customer himself was the Firm's "customer" for purposes of NYSE Rule 405 and, thus, was the proper subject of the items of information called for in the NADs, such as address, investment objectives, and net worth, to the extent that Firm policy required Slezak to fill out those items on the NADs. In short, the NADs contained accurate information about the trusts themselves—whether or not the families for whom the trusts were supposedly named and set up actually existed.

[6] Rule 17a-4 under the Exchange Act merely governs the time period during which any documents that are required to be kept under Rule 17a-3 must be maintained. NYSE Rule 440, meanwhile, simply requires member organizations to "make and preserve books and records as the [NYSE] may prescribe and as prescribed by Rule 17a-3," adding that the "recordkeeping format, medium and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934." Thus, to the extent that no violation of Rule 17a-3 (or of any independent NYSE document-retention rule) was proven, there is, by definition, no violation of Rule 17a-4 or NYSE Rule 440.

170, was found on Slezak's office computer by the Firm's former compliance manager during an internal investigation conducted after Slezak was terminated. Slezak testified that he mailed or hand-delivered the letter without first showing the letter to any of his supervisors because, as he put it, "in [the letter] I tended to puff up myself and inflate my abilities … [a]nd I decided that it probably wouldn't pass muster…." Hearing Transcript ("Tr.") at 1247-48. The Hearing Panel therefore found that Slezak caused a violation of NYSE Rule 342.16 and found him guilty of Charge III.

Charge IV

Charge IV charges Slezak with having violated NYSE Rule 476(a)(6) for engaging in conduct inconsistent with just and equitable principles of trade in three ways: (1) by assisting Customer in opening "fictitious" trust accounts; (2) by purchasing numerous variable annuity contracts with which Customer "improperly timed the market;" and (3) by opening fee-based accounts in which Customer timed the market by investing in international mutual funds.

To sustain a charge of conduct inconsistent with just and equitable principles of trade, we must find that Slezak "acted in bad faith or unethically." Calvin David Fox, Exchange Act Release No. 48,731, 81 S.E.C. Docket 1511, 2003 WL 22467374, at *3 (Oct. 31, 2003); Richard Cutter Matlock Jr., Decision 06-19 (NYSE Hearing Board Mar. 27, 2006).

There is no dispute that Slezak opened 30 trust accounts at Customer's behest, including 13 fee-based accounts, and that Slezak executed numerous purchases of variable annuities in those accounts at Customer's request. There is also little doubt that Customer was "market timing" through those accounts and variable annuities, since he consented to an SEC order dated August 21, 2007, admitted in evidence, in which the SEC found that, during a time period that included 2002, he "engaged in a scheme [that] involved using fictitious family trusts actually owned by [his corporation] to purchase" variable annuities for the purpose of "market timing." Enf. Ex. 200A at 2. However, to find Slezak guilty of violating NYSE Rule 476(a)(6), we must find that Slezak's opening of accounts and execution of variable annuity purchases was done in "bad faith or unethically." We cannot so conclude.

Enforcement's case was circumstantial. Enforcement presented evidence of "red flags" that, Enforcement argued, should have caused Slezak to discover that his customer was engaged in improper market timing through fraudulent means. For example, Slezak created handwritten notes in March 2002 that suggested that Customer had explicitly mentioned that he was using variable annuities and mutual funds to "time [the] mkt [sic]." Enf. Ex. 163C. Also admitted in evidence was a marketing document found on the floor of Slezak's office after he was terminated, which stated that Customer's corporation was engaged in a "mutual fund timing strategy…." Enf. Ex. 164. Enforcement also offered copies of the trust agreements themselves, which allowed a reader to discern that the beneficiaries of the trust were corporate entities ultimately controlled by Customer. Enforcement further pointed out that Customer appointed himself, his close family members, and his employees as annuitants under the variable annuity policies that he purchased in the various trust accounts, which Enforcement argued should have struck Slezak as odd. In addition, Enforcement noted that the list of the 30-plus so-called wealthy Utah mining families, when rearranged, was virtually alphabetical, i.e., one or two family names for each letter from A to W.

However, on closer inspection, each of these supposed "red flags" seems much less obvious when put in context. Indeed, Slezak's conduct must be judged in the context of the time period in which the events of this case took place, rather than on the basis of the common industry practice and knowledge of today. See Isaac Franklin Stevens, Decision 92-133 (NYSE Hearing Board Feb. 26, 1993) ("In judging his actions, the Panel must not apply [today's] knowledge levels and compliance standards to actions that took place a decade and more prior.")

In the spring of 2002, when the relationship between Slezak and Customer began, the concept of "market timing" as it is currently understood, i.e., the excessive trading of international mutual funds to exploit pricing inefficiencies, was not yet common knowledge in the securities industry. Indeed, the Sixth Edition of Barron's Dictionary of Finance and Investment Terms, published in 2003, defines "market timing" as:

> [D]ecisions on when to buy or sell securities, in light of economic factors such as the strength of the economy and the direction of interest rates, or technical indications such as the direction of stock prices and the volume of trading.

Barron's Dictionary of Finance and Investment Terms 410 (6th ed. 2003). The editors of the Barron's Dictionary further noted in 2003 that "[i]nvestors in mutual funds may implement their market timing decisions by switching from a stock fund to a bond fund to a money market fund and back again, as the market outlook changes." Id. Thus, in early 2002, market timing could have been understood as a legitimate trading strategy.

Slezak, who was a trainee in March 2002, was evidently unaware at that time that "market timing" could be a harmful practice or one that often involved deceptive activity, and the Panel does not find such a lack of knowledge to have been unethical at that time. Slezak testified that, in the early part of 2002, he thought the term "market timing" simply meant "buying low [and] selling high." Tr. at 1237-38. See also id. at 1172 (Slezak testifying that he believed investors who were "going to time the market …were simply trying to buy in low when the markets dipped and then try[ing] to sell [their investments] back high.") Having observed Slezak testify over several days during the course of the hearing, the Panel is inclined to take him at his word.

Furthermore, Customer was an experienced, sophisticated, and unscrupulous investor, who hid his deception well. For example, he maintained what appeared to be a legitimate money-management business, he had a plausible answer for every question, and he even hired an attorney to prepare comprehensive legal documentation for each of the trusts, including lengthy trust agreements, which he provided to Slezak, but which a non-lawyer would not necessarily have known how to analyze. As set forth above, Customer also obtained a tax identification number for each of the trusts, which he also submitted to Slezak. In fact, there is no evidence to suggest that the trusts themselves did not actually exist.

As for the alphabetical order of the family names, Enforcement is unfairly using hindsight to prove its case. The alphabetical nature of the list only became obvious once a large number of the trust accounts were opened and the corresponding names were rearranged. The alphabetical nature of the family names was obscured by the fact that several other names appeared in the account documents, such as the Customer-controlled entity acting as trustee and the individual contact person, usually Customer's assistant. Moreover, the family names themselves did not follow a strict alphabetical order until September 2002; in other words, until that time, even if one were to have listed the family names using the chronological order in which the respective accounts were actually opened, that list would not have been alphabetical. Yet all of the accounts were shut down before the end of that month.

The burden of proving the Charge rested with Enforcement. Enforcement did not submit direct proof that Slezak acted knowingly to assist Customer; rather, Enforcement relied on a circumstantial case that Slezak acted in bad faith or unethically in assisting Customer to open accounts and execute variable annuity purchases. That circumstantial evidence included Slezak's motive to act improperly—namely, the significant financial compensation he received in commissions from Customer's business—and the various "red flags" outlined above. However, hindsight is 20-20. Having observed Slezak testify, the Panel is not convinced that Slezak knew what Customer was doing, nor do we find that Slezak acted unethically in failing to make sense of the so-called "red flags" and thereby detect the fraudulent nature of Customer's activity.

NYSE Rule 476(a)(6) requires a registered representative to act ethically; it does not require him or her to a be a human lie detector or a regulatory investigator. Taking all of the evidence together, on balance, we find that it is more likely than not that Slezak acted ethically. We therefore found Slezak not guilty of Charge IV.

II. Charges Against X and Y

The Hearing Panel unanimously found X and Y not guilty of Charges I, II, and III.

<u>Charge I</u>

Between April and September 2002, X, the Wacker branch's assistant branch manager, approved 6 of the total of 30 accounts at issue in this case, and Y, the branch's compliance manager, approved the other 24 accounts. Enforcement contended that, throughout the relevant time period, X and Y failed to use due diligence to learn the essential facts about Customer and his accounts and failed to diligently supervise Slezak's handling of those accounts in violation of paragraphs (1) and (2) of NYSE Rule 405.

However, as explained above, the Panel found that Slezak conducted adequate due diligence prior to the opening of Customer's first accounts in April 2002. In the absence of evidence to the contrary, the Panel infers that X and Y were aware of, and relied on that due diligence, and we find that it was reasonable for X and Y to have done so.

Moreover, the evidence showed that, as early as July 2002, Y brought certain questions he had regarding Customer to GF's attention, and GF directed Y to consult with Slezak, which Y did. Y testified that he had two conversations with Slezak in mid-July. Y told Slezak that it seemed odd that Customer's NADs suggested that the latter was acting as a trustee, whereas Slezak had repeatedly mentioned that Customer was acting as a "money manager." Since the forms that were required for a trust account differed from those required for an account being opened by a money manager, Y asked Slezak to clarify the matter. Slezak suggested that they call Customer together, which they did. Y and Slezak were then told by Customer that he was a trustee, not a money manager. In addition, throughout the relevant period, Y had no override with regard to Slezak's commissions. He thus had no direct personal motive to overlook anything questionable in Customer's account documents, and nothing in the record suggests that he was under any pressure to do so from anyone at the Firm. On the contrary, the evidence established that Y was diligent throughout the relevant period and that he took several affirmative, precautionary measures to ensure the reliability and accuracy of the information that Customer was providing to the Firm. We further infer that Y informed his fellow manager, X, that Y had taken those measures, and we believe it was reasonable for X to have relied on them.

Enforcement also argued that X and Y should have questioned Customer's decision to name himself, his family members, and employees as annuitants in the instructions he provided to the Firm. However, in context, this practice may not have seemed so unusual. After all, X and Y had reason to believe that the beneficiaries of the trusts were wealthy families in Utah; it was conceivable that the families, wanting to protect their privacy, would have agreed to let Customer, or someone designated by him, act as annuitant.

Enforcement also contended that X and Y should have asked more questions about the source of the funds that Customer deposited into the accounts and used to purchase annuities. The evidence showed that some money came from a Utah bank, but that most of the transfers were from one account held at a Chicago bank. Enforcement argued that this should have appeared suspicious to X and Y. However, the Panel finds that, on the contrary, it was reasonable for X and Y to conclude that the funds had a legitimate source. The funds that came from the Utah bank merely corroborated Customer's story. As for the transfers from the Chicago bank account, again, for reasons of privacy, it was not inconceivable that the wealthy families had pooled their resources through Customer, who, in addition to acting as trustee, operated a money-management business in Chicago; this would have explained why the funds often came from the same Chicago-based bank. X and Y had been satisfied, based on Slezak's inquiries, as well as Y's own interactions with Customer in July, that he was a reliable, sophisticated investor who was acting as trustee for these wealthy families. It was reasonable for X and Y not to have questioned the source of funds more than they did.

Enforcement also complained that X and Y should never have approved accounts after the August 13 Meeting, when X and Y had already begun to suspect that Customer was engaged in market timing. However, the accounts opened in September 2002 were fee-based Pilot Plus accounts; unlike the traditional commission-based accounts opened prior to that time, which would only show trading activity in the sub-accounts on a monthly basis—that is, up to weeks after the fact—the Pilot Plus accounts, the evidence established, would enable the Firm to see any purchases or sales of mutual funds executed by Customer in the variable annuity sub-accounts on a T+1 basis. Moreover, all of the trading in the Pilot Plus accounts would be carefully monitored by CSG employees. X testified that this would better enable him and his colleagues to identify any market-timing activity, which is precisely why these fee-based accounts were approved.

X and Y were effectively giving one of their best customers one last chance. If Customer chose to play by the rules, everyone would benefit; if, however, he chose to commit market timing through the annuities in his Pilot Plus accounts, X and Y would have immediate and conclusive evidence of such wrongdoing. This was a reasonable course of action for X and Y. It is unrealistic to expect a firm to fire a very lucrative client without proof that the client is engaged in illicit activity. And, despite the best efforts of X and Y, it wasn't until September that the Firm was able to piece together the necessary evidence—which included the activity observed in the fee-based accounts and a realization about the alphabetical nature of the list of family trust names—to prove that Customer was deceiving the Firm for the purpose of carrying out a market-timing strategy.

In light of the above, we found that both X and Y complied with NYSE Rule 405, and we found them not guilty of Charge I.

<u>Charge II</u>

NYSE Rule 342 provides in relevant part:

> (a) Each office, department or business activity of a member or member organization … shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility. <u>The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees</u> related to the business of their employer and compliance with securities laws and regulations.
>
> (b) <u>The general partners or directors of each member organization shall provide for appropriate supervisory control</u> and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall: (1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control [;][and] (2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

(Emphasis added.)

The Rule has been held to mean that a manager who is entrusted with supervisory responsibility, as X and Y were, must take reasonable steps to ensure compliance with NYSE Rules. <u>See Geoffrey James Barnes</u>, Decision 06-33 (NYSE Hearing Board May 10, 2006) (finding branch office manager violated NYSE Rule 342(a) and (b) for failing to take "reasonable steps to supervise" improper Internet postings made by registered representative regarding securities owned by that registered representative).

Enforcement alleged that both X and Y failed to supervise Slezak adequately and thereby enabled him to assist Customer in opening so-called "fictitious" accounts through which he carried out improper market timing activities. However, the Panel found that X and Y did take reasonable steps to supervise Slezak.

For the first part of the relationship with Customer, things seemed to check out. As noted above, Slezak adequately researched Customer, and X and Y reasonably relied on the information that Slezak had obtained. Furthermore, the legal documentation supporting the trusts was elaborate and persuasive and gave Customer an air of legitimacy. Indeed, strictly speaking, the accounts were <u>not</u> fictitious. For all intents and purposes, the trusts—and therefore, their corresponding accounts—did in fact exist, even if the <u>families</u> who were purportedly the beneficiaries of these trusts were themselves eventually shown to be fictitious. At least for the months of April, May, and June 2002, we cannot say that X and Y failed to reasonably supervise Slezak and the accounts that he opened.

Moreover, as set forth above, in July 2002, Y spoke with Slezak to clear up any confusion as to whether Customer was a trustee or a money manager; Y went so far as to speak directly with Customer, who provided plausible answers that assuaged any concerns that Y had.

It was also reasonable for X and Y not to have discovered Customer's market timing until August or September 2002. As with Slezak, the conduct of X and Y must be considered in the context of the time period in which it occurred. In 2002, as noted above, the common understanding we have today of "market timing" as arbitrage of international mutual funds through excessive trading and, often, deceptive practices, was not as widespread as it is today. The typical assistant branch manager or compliance manager, therefore, may not have understood "market timing" in this way at the time and may not have detected it in the circumstances in which X and Y found themselves in the spring and summer of 2002, particularly when one considers that X and Y were dealing with an experienced, sophisticated investor whose deceptions were well disguised.

Despite Customer's elaborate obfuscations, X and Y were vigilant and did manage to uncover his scheme. In August of 2002, Y took action after reading an article in <u>Barron's Magazine</u> concerning market timing, which caused him to reflect back upon the account activity he had observed in Customer's accounts; it was at that point that he began to suspect that customer was engaged in market timing. Y immediately alerted his superiors, who then convened a meeting to notify Slezak expressly that the Firm would not allow any market-timing activity, and they expected—reasonably so—that Slezak would convey this message to Customer.

All things considered, we believe that X and Y conducted their supervision in a timely, diligent, and reasonable manner. Because of Customer's elaborate scheme, the clues that eventually allowed X and Y to discover Customer's prohibited conduct took time to come together. For example, despite Enforcement's argument that the chargebacks in Slezak's commission runs should have alerted X and Y to the questionable nature of Customer's business, such a finding was not supported by the evidence. Indeed, the first chargeback, which occurred in May 2002 and came to X's and Y's attention in early June, was explained to them by Slezak as being due to a downgrade in the issuer of the annuity that was cashed in. This was a plausible explanation. As for the chargebacks that occurred in June and came to X's and Y's attention in July, they were a relatively small percentage of Slezak's total commissions and, therefore, may not have raised a concern at the time. Similarly, the bulk of the stop letters from annuity companies only began coming into the Firm on or around September 11, 2002. Measures were taken by X and Y, as well as others, to shut down Customer's ability to trade in his sub-accounts within weeks. We find that X's and Y's actions in this regard were reasonable.

As for the Pilot Plus accounts that X and Y approved in early to mid-September 2002, they further enhanced the Firm's ability to identify Customer's misconduct. Compliance for those accounts was handled primarily by the Firm's CSG employees. We hold that it was reasonable for X and Y to rely on CSG employees to monitor the trading in the Pilot Plus accounts; this was effectively an appropriate delegation of supervisory responsibility. And it was undisputed that a CSG supervisor conclusively identified market timing by Customer on September 23, 2003—only 18 days after the opening of the first Pilot Plus accounts that X had approved that month. In short, the procedures in place worked to root out the prohibited conduct by Customer within a reasonable time frame.

The Firm did the right thing by firing Customer in late September 2002, once the evidence that Customer was engaged in improper activities was conclusive—which was made possible, at least in part, thanks to the diligent efforts and persistence of X and Y. On or around Friday, September 20, 2002, X became aware of an e-mail to Slezak from a variable annuity company informing him that one of Customer's sub-accounts had been barred from any further mutual fund trading; the e-mail came to X's attention because Slezak had forwarded it to Customer, and the Firm's e-mail system therefore routed it to X for supervisory review. X was concerned by what he saw in the e-mail and, as a result, he immediately went back and reviewed (or re-reviewed) the information for all of the accounts that Customer had opened. Using an Excel spreadsheet, he sorted the list of accounts by the name of the family on whose behalf the trust was allegedly established. It was at that point that X realized the family names were virtually alphabetical. This was the final piece of the puzzle. On the following business day, Monday, September 23, 2002, X brought the situation to GF's attention; X also began a comprehensive investigation, which included reviewing the transactions in Customer's sub-accounts and contacting many of the affected annuity companies to prevent future market timing. Three days later, on September 26, 2007, Customer was fired.

Enforcement faulted X and Y for not uncovering Customer's fraud and firing him sooner, but the Panel believes that such a position disregards the practical realities of a brokerage business. First, the decision to fire Customer was not one for X or Y to make. Second, as soon as X and Y began to have suspicions about Customer, they asked questions, reviewed Firm records, and kept their branch officer manager in the loop. The fact is, X and Y were frequently the ones pushing their branch manager, GF, to take action. In any event, based on the combined experience of this Panel, which totals several decades in the brokerage industry, we know that the firing of a customer is an extreme measure that is only appropriate after a firm has acquired solid evidence of misconduct by the customer, as the Firm did, in this case, by late September 2002.

In an ideal world, perhaps X and Y would have uncovered Customer's questionable activity sooner. Indeed, their supervision was not perfect. However, that does not mean they were in violation of NYSE Rule 342. The Rule does not impose a standard of perfection; rather, it requires that a supervisor "reasonably discharge his duties and obligations [of] … supervision and control…." NYSE R. 342(a) (emphasis added); see also X & Y, Decisions 99-171 & 99-172, at 8 (NYSE Hearing Board Dec. 8, 1999) ("We hold [a] branch manager to standards of reasonable and diligent supervision, not to perfection.").

We find that X and Y took reasonable steps to verify the information in the account records they were approving for Slezak and to monitor the activity in Customer's accounts and sub-accounts. Taking all of the evidence together, we find that X and Y carried out their supervisory responsibilities in a reasonable manner. We therefore found X and Y not guilty of Charge II.

Charge III

As explained above with regard to Charge II against Slezak, Exchange Act Rule 17a-3 did not require X and Y to go behind the trusts or to obtain information about the purported beneficiaries of Customer's accounts, namely, the apparently fictitious wealthy Utah families. Consequently, we found there was, as a matter of law, no violation of Rules 17a-3 and 17a-4 under the Exchange Act or of NYSE Rule 440, and X and Y were, therefore, not guilty of Charge III.

PENALTY

The only penalty that the Panel was required to determine was that to be imposed on Slezak for the one Charge on which he was found guilty—his failure to obtain supervisory approval of a letter sent to a potential client. Enforcement recommended a penalty of a censure, and Slezak did not argue in favor of any specific penalty.

Given the minor and technical nature of Slezak's sole violation and the lack of evidence of any harm resulting from that violation, the Hearing Panel found that the penalty of a censure would be reasonable and appropriate.

For the Hearing Panel

Vincent F. Murphy - Hearing Officer
Panelists: Timothy Taylor
Jerome K. Rumps