SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 69923 / July 2, 2013

Admin. Proc. File No. 3-14609

In the Matter of the Application of

WILLIAM J. MURPHY and CARL M. BIRKELBACH

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY PROCEEDINGS

Discretionary Trading Without Written Authorization

Unauthorized Trading

Unsuitable Trading

Churning

Misleading Communications

Failure to Supervise

Registered securities association found that registered representative, while associated with member firm, engaged in discretionary trading without written authorization, engaged in unauthorized trading, engaged in unsuitable and excessive trading, churned customer accounts, and caused the creation and distribution of inaccurate, unbalanced and misleading communications. The association also found that president of member firm failed to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations and with association rules. *Held*, association's findings of violations and sanctions imposed are *sustained*.

APPEARANCES:

William J. Murphy, pro se.

James J. Moylan, of James J. Moylan and Associates, P.C., for Carl M. Birkelbach.

Marc Menchel, *James Wrona*, and *Michael J. Garawski* for Financial Industry Regulatory Authority, Inc.

Appeal filed: October 28, 2011
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I.

William J. Murphy and Carl M. Birkelbach, formerly associated with Birkelbach Investment Securities, Inc. ("BIS"), appeal from FINRA disciplinary action.[1] FINRA found that Murphy (i) engaged in discretionary trading without written authorization in violation of NASD Rules 2510(b), 2860(b), and 2110; (ii) engaged in unauthorized trading and trading beyond approved levels in a customer's account in violation of NASD Rule 2110; (iii) engaged in unsuitable and excessive trading in violation of NASD Rules 2310, 2860, and 2110; (iv) churned customer accounts in violation of Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rule 10b-5, and NASD Rules 2120, 2310, and 2110; and (v) caused the creation and distribution of inaccurate, unbalanced and misleading communications in violation of NASD Rules 2210, 2220, and 2110. Based upon these violations, FINRA barred Murphy from associating with any member firm in any capacity and ordered him to pay $585,174.67 in disgorgement. Additionally, FINRA found that Birkelbach failed to supervise Murphy in violation of NASD Rules 3010, 2860(b), and 2110. For his supervisory failures, FINRA barred Birkelbach in all capacities. We base our findings on an independent review of the record.

II.

Applicants had long careers in the securities industry. Murphy entered the industry in 1985 and became associated with BIS in 1995. Murphy was registered as a general securities representative and general securities principal, and he eventually became the second-ranking

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[1] FINRA is a private, not-for-profit, self-regulatory organization registered with, and overseen by, the Securities and Exchange Commission. It was created in July 2007 following the consolidation of the National Association of Securities Dealers, Inc. and the member regulation, enforcement, and arbitration functions of the NYSE Regulation, Inc. *[No Name in Original]*, Exchange Act Release No. 56751, 2007 WL 4302651, at *1 (Nov. 6, 2007); *Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes To Accomm. the Consol. of the Member Firm Regulatory Functions of NASD and NYSE Reg., Inc.*, Exchange Act Release No. 56145, 2007 WL 5185330, at *29 (July 26, 2007). Though this case was instituted after the consolidation, some of the conduct at issue took place before then. Accordingly, this opinion refers to those conduct rules that were in place at the time.

officer at BIS. Birkelbach founded BIS in 1983 and served as its president. Birkelbach was registered as a general securities representative and general securities principal, a municipal securities representative and municipal securities principal, an options principal, and a financial and operations principal. The conduct at issue took place between 2002 and 2007 and involved the accounts of two BIS customers: Amy Lowry and Benjamin Martinelli.

A. Murphy's management of Lowry's account

Lowry is a mother of three, a writer and illustrator of children's books, and a painter. In 1998, Lowry's father, who had been an executive at Proctor & Gamble ("P&G"), placed approximately 47,000 shares of P&G stock worth approximately $4 million in a trust for Lowry's benefit. Lowry, as trustee, deposited the shares in an account at Fidelity Investments. Lowry's father died in 1999, and Lowry divorced the same year.

In 2001, a trader friend of Lowry's, Frank DeMaria, suggested that she consider a covered call strategy of options trading as a way to generate additional income from her P&G stock.[2] A covered call strategy involves "writing" (*i.e.*, selling) covered call options and "is commonly used by investors who desire to increase the income which they derive from ownership of stock."[3] After explaining the basics of the covered call strategy to Lowry, DeMaria then helped Lowry write ten covered call options on P&G stock in her Fidelity account. DeMaria suggested that Lowry talk with Pat Jage, a registered representative at BIS, about opening an account at BIS in order to pursue a covered call strategy.

In October 2001, Lowry opened an options and margin account with Jage at BIS, where she deposited 20,000 shares of P&G stock, which at the time were valued at approximately $1.5 million. The account documentation, which included a new account form and an option

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[2] With respect to Lowry's account, this case involves the trading of stock options. Options are divided into two types: calls and puts. "A call option gives the buyer the right to buy shares (usually 100) of the underlying security at the stated exercise price within a specified period of time. A put option gives the buyer the right to sell such shares at the exercise price within the specified period. The exercise price (striking price) is the fixed price per unit at which the holder of the option may purchase or sell the underlying stock." *Thomas J. Furnari*, Exchange Act Release No. 21046, 47 SEC 1074, 1984 WL 472728, at *1 n.2 (June 14, 1984). "Writing a covered call" means to sell an option while maintaining the underlying stock. Conversely, "[a] call writer selling a naked (uncovered) option does not own the underlying security." *Id.*

[3] Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 Bus. Law. 571, 589 (1984). A covered call strategy has the potential to generate income because the covered call writer receives a premium from selling the call. If the price of the underlying security never exceeds the exercise price before the option expires, then the buyer of the option will not exercise the option. The call option thus expires worthless, allowing the call writer to retain the premium as profit. If, however, the price of the underlying security exceeds the exercise price before the option expires (*i.e.*, the option is "in the money"), then the call buyer will exercise the option, and the covered call writer will be required to sell the underlying security to the call buyer at a price lower than the market price. To avoid having to sell the underlying security to the call buyer, the covered call writer may buy back the identical call option at a loss (because the option now has a higher price) before the option is exercised. This is called a closing or liquidating transaction.

agreement and approval form, indicated that Lowry was a 44-year-old, self-employed, single mother with three dependents and an annual income of "$55,000+."[4] The bulk of her annual income came from dividends from her P&G stock. The new account form indicated that her "liquid net worth excluding her residence" was "$2,500,000+."[5]

The account opening documents noted that Lowry's investment objectives were "income," "long-term growth," and "income & appreciation," and her risk exposure level was "moderate."[6] Lowry's overall objective was to generate income without having to sell her P&G stock. She did not want her P&G stock to be called away (*i.e.*, sold to satisfy an obligation on a call option) because she had an emotional attachment to P&G and because she had a low tax basis in the stock. The option agreement, which was reviewed and signed by Birkelbach, approved Lowry's account only for "covered writing" and "buying" of stock options.[7] The account forms did not approve Lowry's account for discretionary trading.

Although she previously had accounts that held securities, Lowry had no prior experience with securities trading other than once trading some Ben & Jerry's stock and the P&G options transactions she had executed with DeMaria's help.[8] Lowry's testimony demonstrates that, while she had a rudimentary understanding of the covered call strategy, she lacked a sophisticated understanding of options trading.

Jage handled Lowry's account until July 2002, when he abruptly left BIS due to illness. During the time he managed the account, Jage wrote only covered calls, and when he left BIS, Lowry's account was valued at approximately $1.7 million and had no margin debt. Following Jage's departure, Birkelbach transferred Lowry's account to Murphy. Around the time Murphy

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[4] Exs. JX-15, JX-16.

[5] Ex. JX-15. The option agreement indicated that she had "cash" of "$2,500,000+," "marketable securities" of "$2,500,000+," "real estate (exclusive of family residence)" worth $350,000, and a "total net worth" of "2,500,000+." Ex. JX-16. But Lowry testified that, contrary to what the option agreement reflected, she kept a cash balance of only about $20,000 to $30,000.

[6] Ex. JX-15.

[7] Ex. JX-16. Lowry signed the original option agreement again on November 1, 2004. *See* Ex. JX-17. Lowry testified that she believed she was simply re-signing the agreement so that her account paperwork would reflect a name change (she had stopped using her first husband's last name). At some point, however, the agreement was altered to indicate that the account was approved for both "uncovered writing" and "spreading" (an options strategy that involves buying and selling equal numbers of options of the same type on the same underlying security but with different strike prices or expiration dates). The parties stipulated that in November 2004 Birkelbach approved the account for uncovered options writing, but Lowry testified that neither Birkelbach nor Murphy informed her that her account was being approved for uncovered writing and spreading.

[8] Despite this fact, the new account form indicated that she had ten years of investment experience, and the option agreement indicated that she had 25 years of investment experience with stocks and bonds and one year of experience with options. Lowry testified that Jage knew she had no trading experience but he told her that inflating her investment experience on the opening documentation was "a common thing to do" and would "facilitate the opening of the account" and allow her to pursue the covered call strategy. Transcript of Hearing ("Tr.") at 120.

took over the account, Lowry expressed concerns to him about trading losses and commissions during the time Jage handled the account. Murphy apologized and told Lowry that he would lower the commissions and that the account would make money going forward. Lowry told Murphy to continue to pursue the covered call strategy and reiterated that she did not want her P&G stock called away. Lowry testified that she trusted Murphy and gave him oral permission to execute trades in her account without prior approval from her. But Lowry never provided written authorization for Murphy to exercise trading discretion in her account.

After Murphy was assigned to Lowry's account, trading in the account increased dramatically. Between July 2002 and February 2006, Murphy made 2,594 options trades involving more than 67,000 P&G option contracts. Murphy frequently traded options in Lowry's account several times a week—sometimes multiple times on a single day. At the peak of his trading in the account, between November 2004 and January 2006, Murphy traded between 4,000 and 8,000 option contracts per month. Murphy's trading involved numerous "round-trip" trades, meaning that he would repeatedly sell and buy back the same series of option contracts. For example, between August 5, 2004, and January 5, 2005, Murphy effected 11 round-trip trades of P&G call options with a January 2005 expiration and a $55 exercise price, which resulted in a loss of $74,162, including $34,142 in commissions. Murphy's trading activity ultimately generated over one million dollars in commissions during the approximately three-and-a-half years he was assigned to the account. During this time, the account also incurred substantial trading losses and a large margin debit balance. Between October 2003 and February 2006, Lowry's account consistently ran a margin debit balance, with the month-end margin debit balance reaching as high as $1.16 million (on July 31, 2005). Lowry ultimately paid $125,034 in margin interest. For the period Murphy was assigned to the account, the annualized cost-to-equity ratio—the amount the account would have to appreciate to break even—was 25.59%.[9] The cost-to-equity ratios for 2004 and 2005 were even higher, at 31.25% and 48.56%, respectively.

In addition to the high volume of trading in the account, Murphy also engaged in a substantial number of transactions that were not part of a covered call strategy and that went beyond the type of trades orally agreed to by Lowry and authorized by her BIS option agreement. Although Jage had confined his trading in Lowry's account to pursuing the covered call strategy, Murphy almost immediately upon being assigned to the account began trading that was not part of a covered call strategy: he wrote uncovered calls, uncovered puts, and combinations.[10] Such trading was frequent, with Lowry's account holding option positions that were not covered calls at the end of every month between July 2002 and October 2004.

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[9] Without taking margin interest into account, the annualized cost-to-equity ratio during the same time period was 22.75%.

[10] "A combination is any strategy involving the purchase or sale of both puts and calls." *Furnari*, 1984 WL 472728, at *1 n.2.

Murphy spoke with Lowry on the phone approximately once a month at the start of his management of her account and more frequently near the end. But Murphy did not consult with Lowry before executing each trade, and he never told her that he was pursuing options trading beyond a covered call strategy. Lowry received account statements, but she did not regularly review them and did not understand them when she did—a fact that Lowry told Murphy.

Moreover, many of the statements that Murphy caused to be created and sent to Lowry contained errors and inconsistencies. For example, at Murphy's direction, profit and loss reports were sent to Lowry that purported to show the options transactions that occurred during the period covered by the report and the resulting profits and losses by option series and in total. Twelve of the sixteen profit and loss reports sent to Lowry included overstatements of the account's total profits, with errors in the total profit figures ranging from a few hundred dollars to over $38,000.[11] In addition, a report sent to Lowry some time after 2005, purporting to show the change in Lowry's account balance over several years, calculated the change in the account's value in an inconsistent manner, which resulted in the report providing inaccurate information for multiple years.

Lowry raised concerns to Murphy about the handling of her account on a few occasions, but Murphy downplayed her concerns and told her not to worry because her account was profitable. For example, in late 2003, after receiving an activity letter from George Langlois, the BIS compliance officer, indicating that year-to-date commissions in her account were $251,781, Lowry called Murphy to express her concern. Murphy told Lowry that the commissions "didn't matter" because "the account was profitable" and she "was making money."[12] Murphy also misled Langlois by telling him that Lowry was approving each of the trades in the account. Then in early 2005, Lowry's accountant, Mark Pesavento, was preparing her tax returns and informed Lowry that she had incurred a substantial loss in her BIS account exceeding $300,000, and she learned that her margin debit balance had "grown huge."[13] "[A]larmed and upset," Lowry called Murphy to ask what had happened.[14] Murphy tried to reassure her by explaining that the margin debit balance "wasn't a true indication" of the margin in her account—an explanation that Lowry did not understand.[15] Around April 2005, Lowry began to meet with Murphy, Pesavento, and Karen DeRose, a financial planner Lowry had engaged at the suggestion of Birkelbach. At one such meeting, Lowry told Murphy to "be conservative and stop the bleeding" in her account.[16] Lowry also for the first time authorized Murphy to let her P&G stock get called away to bring down the margin balance. In May 2005, BIS began to send duplicate copies of Lowry's account statements to Pesavento and DeRose.

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[11] On occasion, the statements also understated the account's profits.

[12] Tr. at 148.

[13] *Id.* at 152-53.

[14] *Id.* at 153.

[15] *Id.*

[16] *Id.* at 156.

In December 2005, Lowry learned from Pesavento that Murphy had continued to trade heavily in her account. Around this time, FINRA contacted Lowry about Murphy's handling of her account in connection with an investigation into Murphy's conduct. In January 2006, Lowry sent a letter to Murphy instructing him to cease options trading in her account. Lowry closed her BIS account in April 2006, after transferring the assets in the account to Fidelity. Murphy's options trading in Lowry's account ultimately generated trading losses totaling $871,301.95 and commissions totaling $1,002,100.[17] From the third quarter of 2002 through the end of 2005, Murphy's trading in Lowry's account accounted for 59% of Murphy's overall commissions and 18% of BIS's total revenues. After closing her BIS account, Lowry brought an arbitration claim against BIS, which was eventually settled for $150,000.

B. Murphy's management of Martinelli's account

In May 1999, while he was a college student in Chicago, Illinois, Martinelli opened an account with George Langlois at BIS. Under Langlois's management, Martinelli's account grew from the $2,500 he deposited between 1999 and 2001 to over $18,000 in March 2007, mainly through investments in low-priced securities. In April 2007, Langlois left BIS, and Birkelbach assigned Martinelli's account to Murphy. At this time, Martinelli was an active member of the United States military and stationed in Germany. Shortly after learning of the account transfer, Martinelli called Murphy to discuss his account. Murphy told Martinelli that he wanted to handle the account differently than had Langlois. Specifically, he proposed to use a "little more conservative approach" and "not deal with penny stocks."[18] Martinelli told Murphy that this approach sounded reasonable but that he wanted to think about it and would get back to Murphy. At no point did Martinelli provide written authorization for Murphy to exercise discretion in his account.

Because of a delay in receiving his mail overseas, Martinelli did not receive his April 2007 account statement from BIS until late May or early June 2007. When he received the statement, he was surprised to see that Murphy had actively traded in his account, even though he had not given Murphy permission to do so. Murphy's trading in Martinelli's account in April included dozens of transactions, including the liquidation of four of the five stocks in the account and several in-and-out trades. The trading resulted in costs of $2,132 and caused the value of Martinelli's account to drop to $15,387.34—a 17% drop in a single month. Upon receiving the April statement, Martinelli called Murphy to ask why he had been trading in the account at all. Martinelli also complained that the commissions were significantly higher than he had paid with Langlois. According to Martinelli, Murphy responded by suggesting that there had been a misunderstanding and by offering to refund $3,000 in commissions. Murphy also told Martinelli

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[17] Because the value of Lowry's P&G stock increased considerably during the time she maintained an account at BIS, her net loss during the time her account was open at BIS was approximately $93,821, when accounting for options trading losses, the marked-to-market value of her P&G stock, dividends received, mutual fund distributions, commissions paid, and margin interest.

[18] Tr. at 55.

that his account was worth about $13,000. Martinelli told Murphy that he wanted to transfer his account to Langlois, who was now at a different firm, and that he wanted Murphy to stop trading in his account.

When Martinelli eventually received his May 2007 account statement he discovered that matters were worse than Murphy had led him to believe. Throughout May 2007, Murphy had continued to actively trade in the account, including several in-and-out trades over a short time period. By the end of May 2007, around the time of Martinelli's phone conversation with Murphy, the account value had plummeted to $10,134.46—a 45% decline in only two months. Account costs for May 2007 were $3,257. In July 2007, after he received the May 2007 statement, Martinelli called both Murphy and Birkelbach to complain. The same month, Martinelli closed his BIS account and transferred his assets to Langlois's new firm. During the three months Murphy managed Martinelli's account, Murphy's trading (which had never been authorized by Martinelli) involved 26 trades in 14 different stocks, resulting in approximately $5,395 in commissions and $5,703 in losses. The annualized turnover ratio—the number of times per year the securities in an account are replaced by new securities—was 22.62, and annualized cost-to-equity ratio was 169%.

On July 12, 2007, Martinelli sent a formal letter of complaint to FINRA and the Illinois Securities Department, with a copy to Birkelbach. In January 2008, Martinelli agreed to settle his dispute with BIS regarding Murphy's handling of his account for $4,758.05.

C. Birkelbach's supervision of Murphy

During the time Murphy managed Lowry's account, Birkelbach had ultimate supervisory responsibilities regarding Murphy's options trading because he was the Senior Registered Options Principal and Compliance Registered Options Principal. All options trades required his approval, and he reviewed the options trades daily to ensure that they were suitable. Birkelbach testified that to trade uncovered options a customer's investment objective would have to be "speculative or high risk."[19] In addition to reviewing and approving Murphy's options trading, Birkelbach also had responsibility for reviewing profit and loss reports and correspondence sent by Murphy to Lowry.

As Murphy's boss at BIS since 1995, Birkelbach knew before he assigned Lowry's account to Murphy that Murphy had a disciplinary history related to options trading as well as a history of customer complaints and arbitrations. For example, in 1999, the Commission sustained findings by the Chicago Board Options Exchange, Inc., that Murphy had traded without prior authorization from a customer and had exercised discretion without prior written authorization from a customer and written approval from his broker-dealer. Murphy was

[19] Ex. JX-202, at 57.

censured, barred from associating with any exchange member firm for two months, and fined $10,000.[20]

Langlois, who served as the compliance officer during the time Murphy handled Lowry's account, frequently raised concerns to Birkelbach about Murphy's very active trading in Lowry's account, including the high level of commissions. Birkelbach agreed with requests by Langlois to send activity letters to Lowry, which noted a "high level of activity" in her account and sought the assurance that she was "financially able to assume the risk associated with active trading."[21] Birkelbach, however, never followed up personally with Lowry about the activity letters or the nature and level of trading in her account more generally.[22] Moreover, Birkelbach never disapproved any trades made by Murphy in Lowry's account.

Birkelbach was also responsible for supervising Murphy's handling of Martinelli's account. Long before he assigned Martinelli's account to Murphy, Birkelbach knew that FINRA was investigating Murphy for misconduct related to Lowry's account. In November 2005, FINRA had asked Birkelbach to put Murphy on heightened supervision. There is no evidence that Birkelbach changed his supervisory approach to Murphy in any way. Although Birkelbach reviewed Murphy's trading in Martinelli's account, which included short-term, in-and-out trading, he never disapproved any trades made by Murphy in the account.

D. Procedural history

After a routine examination of BIS in which FINRA examiners reviewed trading in Lowry's account, FINRA launched a formal investigation in November 2005 that led to this proceeding. On July 30, 2008, FINRA's Department of Enforcement issued a nine-count complaint against Murphy, Birkelbach, and BIS. After a four-day hearing, a FINRA hearing panel issued a decision on May 6, 2011, finding violations on all but two counts in the complaint. In reaching its findings, the hearing panel made express determinations that Murphy was not a credible witness and that Martinelli was a "very credible" witness.[23] Based on the finding of violations, the hearing panel barred Murphy from associating with any member firm and ordered him to pay $591,933.67 in disgorgement; suspended Birkelbach for six months as a general securities principal and options principal and fined him $25,000; and fined BIS $2,500.

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[20] *William J. Murphy*, Exchange Act Release No. 41804, 54 SEC 303, 1999 WL 668560, at *5 (Aug. 27, 1999).

[21] Exs. JX-80 through JX-87.

[22] Lowry testified that when she asked Murphy about the activity letters, he suggested they were a formality and she should simply sign and return them.

[23] *Dep't of Enforcement v. Murphy*, Complaint No. 2005003610701, 2010 WL 5129558, at *6 n.10, *7 n.12 (OHO May 6, 2010). The hearing panel made no further express credibility determinations but, in making its findings, relied on aspects of Lowry's testimony as well as on some of the testimony of Langlois, Pesavento, DeRose, Julie Murphy (a FINRA investigator), and Marc Allair (FINRA's expert witness). The hearing panel did not rely on any of Birkelbach's testimony except for statements he made against his own interest.

Murphy, Birkelbach, and BIS appealed the hearing panel's decision to FINRA's National Adjudicatory Council. On October 20, 2011, the NAC issued a decision affirming all of the hearing panel's findings of violations.[24] With regard to sanctions, the NAC affirmed the bar against Murphy but decreased the disgorgement amount by $6,759 to reflect a $5,000 fine Murphy had paid to the Illinois Securities Department for his misconduct in connection with Martinelli's account and $1,759 in commissions for which Martinelli had been reimbursed. The NAC increased Birkelbach's sanction to a bar in all capacities and affirmed the $2,500 fine imposed on BIS.[25] In support of its decision to increase Birkelbach's sanction, the NAC found that the hearing panel's sanction was "wholly insufficient to remedy his failure to supervise" and that his "conduct reflect[ed] a shocking disregard for FINRA rules designed to protect customers."[26]

III.

Section 19(e) of the Exchange Act provides that, in reviewing a disciplinary proceeding by a self-regulatory organization, we shall determine whether the associated person engaged in the conduct found by the SRO, whether the conduct violated the SRO rules at issue, and whether those rules were applied in a manner consistent with the purposes of the Exchange Act.[27] In conducting our *de novo* review, we apply a preponderance of the evidence standard to determine whether the record supports FINRA's findings that Murphy and Birkelbach violated its rules.[28] Based on our independent review of the record, we find that a preponderance of the evidence supports FINRA's findings of violations.

A. Murphy engaged in discretionary trading without written authorization.

FINRA found that Murphy engaged in discretionary trading without written authorization in violation of NASD Rules 2510(b), 2860(b), and 2110.[29] Rule 2510(b) provides that "[n]o . . . registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization" and that the account must be approved for

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[24] *Dep't of Enforcement v. Murphy*, Complaint No. 2005003610701, 2011 WL 5056463 (NAC Oct. 20, 2011).

[25] FINRA found that BIS violated NASD Rule 2110 by including an improper confidentiality provision in a settlement agreement with a client that had the potential to impede the investigation of this case. Before the Commission, BIS has voluntarily withdrawn its appeal of this finding, and it has paid the associated $2,500 fine.

[26] *Murphy*, 2011 WL 5056463, at *35, *37.

[27] 15 U.S.C. § 78s(e).

[28] *See, e.g.*, *Richard G. Cody*, Exchange Act Release No. 64565, 2011 WL 2098202, at *9 (May 27, 2011), *aff'd*, 693 F.3d 251 (1st Cir. 2012).

[29] NASD Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." According to "our long-standing and judicially-recognized policy . . . a violation of another Commission or NASD rule or regulation . . . constitutes a violation of [NASD] Rule 2110." *Stephen J. Gluckman*, Exchange Act Release No. 41628, 54 SEC 175, 1999 WL 507864, at *6, (July 20, 1999).

discretionary trading in writing by the member firm. With regard to options trading, Rule 2860(b)(18)(A) further provides that a representative may not exercise discretionary authority in a customer's account unless the trading complies with Rule 2510, the customer's written authorization for discretionary trading "specifically authorize[s] options trading in the account," and the account is accepted in writing for discretionary trading by a Registered Options Principal.

As we recognized in an earlier disciplinary proceeding involving Murphy, "[d]iscretionary trading in a customer's account is a practice that is inherently susceptible to abuse."[30] In light of this potential for abuse, FINRA's rules require that the authorization for the exercise of discretionary power in a customer's account be in writing. It is undisputed that neither Lowry nor Martinelli gave Murphy prior written authorization for any discretionary trading in their accounts. Lowry gave Murphy oral permission to make trades in her account without her prior authorization. While Murphy contends that he understood Martinelli to have given him oral permission to pursue the strategy they discussed, we do not believe that to be the case.[31] In any event, oral permission is insufficient to exercise discretionary power in a customer's account under Rule 2510. Likewise, neither account was approved in writing for discretionary trading by BIS. And Lowry's account was not approved for discretionary options trading by a Registered Options Principal. Despite the lack of written authorization, Murphy exercised discretionary power in both Lowry's and Martinelli's accounts by executing numerous trades for which neither customer gave prior approval. The record thus amply supports a finding that Murphy violated FINRA's rules on discretionary trading.

Murphy argues[32] that his trading in Lowry's account fell within the "time and price discretion" exception to Rule 2510, as it existed prior to January 31, 2005.[33] The exception permits a registered representative to "exercise discretion as to the price at which or the time when an order by a customer for the purchase or sale of a definite amount of a security shall be executed." But the time and price discretion exception does not excuse Murphy's discretionary trading here. For the exception to apply, Lowry would have had to direct Murphy to buy or sell

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[30] *Murphy*, 1999 WL 668560, at *3.

[31] Murphy testified that he understood Martinelli to give him authority to trade without talking to him first, but the hearing panel generally found Murphy to be not credible. On the other hand, Martinelli, whom the hearing panel described as "very credible," testified that he "hadn't given [Murphy] the authorization to trade." Tr. at 56. On cross-examination, Martinelli testified that when he told Murphy that the proposed investment approach "sounded reasonable" he was not authorizing Murphy to realign the portfolio, but he acknowledged that, if Murphy "really wanted to take it that way," it was possible that Murphy could have misunderstood. *Id.* at 77.

[32] Upon notice from Murphy that he would represent himself *pro se* before the Commission, the Commission granted his request to consider his prior pleadings in support of his application for review. Accordingly, in our *de novo* review of the alleged violations by and sanctions imposed on Murphy, we have considered the arguments Murphy raised before the hearing panel and the NAC as if raised before the Commission.

[33] On January 31, 2005, the exception was amended to state that "time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer."

a definite amount of a security, but there is no evidence that she ever gave Murphy any such direction. Put another way, Murphy's trading did not involve the exercise of discretion only over the timing and prices related to the options transactions in Lowry's account, but also over the type and quantity of options transacted. The record demonstrates that Murphy exercised complete discretion over what specific option series to buy or sell and at what quantities, in addition to exercising discretion with regard to time and price. And, contrary to Murphy's suggestion, the fact that Lowry approved the covered call strategy does not mean that Murphy's trading—which involved exercising discretion over the type and quantity of options traded—would come within the time and price discretion exception.[34] Furthermore, Murphy's argument does not excuse the discretionary trading that took place in Lowry's account after January 2005 and in Martinelli's account for the entire time Murphy managed it. Murphy apparently concedes that this trading could not fall within the amended time and price discretion exception, which limits the exercise of such discretion to one business day.

For all of these reasons, we sustain FINRA's finding that Murphy violated Rules 2510(b), 2860(b), and 2110 by engaging in discretionary trading without proper authorization.

B. Murphy engaged in unauthorized trading in Lowry's account.

FINRA also found that Murphy violated NASD Rule 2110 by engaging in trading that was not authorized by Lowry and that went beyond the level approved by BIS for her account. "An associated person is 'responsible for obtaining his [or her] customer's consent prior to purchasing a security for the customer's account.'"[35] We have recognized that "[u]nauthorized trades are a serious breach of the duty," set forth in Rule 2110, "to observe high standards of commercial honor and just and equitable principals of trade."[36] Unauthorized trading "goes 'to the heart of the trustworthiness of a securities professional,' and 'is a fundamental betrayal of the duty owed by a sales[person] to his [or her] customers.'"[37]

Lowry directed Murphy to pursue a covered call strategy and Murphy told Lowry he would pursue that strategy. There is no evidence that Murphy ever received authorization from Lowry to pursue trading beyond the covered call strategy. Nevertheless, Murphy frequently

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[34] Even if we were to accept Murphy's contention that Lowry's approval of the covered call strategy granted Murphy some degree of discretion, it would not authorize his trading because, as discussed more fully below, Murphy deviated significantly from the covered call strategy agreed to by Lowry.

[35] *Wanda P. Sears*, Exchange Act Release No. 58075, 2008 WL 2597567, at *2 (July 1, 2008) (quoting *Carlton Wade Fleming, Jr.*, Exchange Act Release No. 36215, 52 SEC 409, 1995 WL 539462, at *3 (Sept. 11, 1995)).

[36] *Janet Gurley Katz*, Exchange Act Release No. 61449, 2010 WL 358737, at *22 (Feb. 1, 2010) (quoting *Sears*, 2008 WL 2597567, at*2); *see also Gregory W. Gray, Jr.*, Exchange Act Release No. 60361, 2009 WL 2176836, at *7 (July 22, 2009) (recognizing that unauthorized trading is inconsistent with just and equitable principles of trade); *Michael G. Keselica*, Exchange Act Release No. 34929, 52 SEC 33, 1994 WL 615112, at *3 (Nov. 3, 1994) (same).

[37] *Katz*, 2010 WL 358737, at *22 (quoting *Adam Stuart Levine*, Exchange Act Release No. 32214, 51 SEC 395, 1993 WL 138530, at *2 (Apr. 26, 1993) and *Sears*, 2008 WL 2597567, at *2).

engaged in options trades that were not part of the covered call strategy agreed to by Lowry. He wrote uncovered calls, uncovered puts, and combinations—trades that Murphy's own expert witnesses agreed were not part of a covered call strategy. Because he conducted numerous trades that were clearly outside the strategy agreed to by Lowry, we sustain FINRA's finding that Murphy engaged in unauthorized trading in violation of Rule 2110.

We also sustain FINRA's finding that, in the circumstances of this case, Murphy violated Rule 2110 by pursuing trading in Lowry's account not approved by BIS. Prior to November 2004, Lowry's option agreement authorized only "covered writing" and "buying of stock options"—the box on the agreement authorizing uncovered writing was left unchecked. Yet, during this time, Murphy did not limit his trading to the categories authorized in the option agreement but instead wrote numerous uncovered options.

While acknowledging that some trades "were technically outside" the approved types of transactions on the option agreement, Murphy argues that his unauthorized trading should be excused because "a portion of the uncovered positions were caused by Lowry" who used some of her P&G stock as collateral to obtain a $500,000 bridge loan.[38] In 2004, Lowry bought a new residence and pledged some of her P&G stock as collateral in order to secure a bridge loan necessary to finance the purchase. But even if some of the uncovered positions can be attributed to Lowry's pledging a portion of her P&G shares to secure the loan, this does not explain or excuse the numerous uncovered calls Murphy wrote before June 2004, when Lowry used her stock to secure the loan.

Murphy also contends that "Lowry approved and insisted upon the strategy employed by Mr. Murphy during the time he handled her account."[39] But there is no evidence that Lowry agreed to or insisted upon a strategy involving uncovered option writing. Lowry asked for and agreed to only a covered call strategy. Lowry further testified that she believed throughout the time Murphy handled her account that he was pursuing only that strategy. Lowry could not have approved and insisted upon a strategy that she was not even aware Murphy was pursuing.

To the extent Murphy is arguing that an alleged demand by Lowry for $10,000 per month in income justified the type of options trades he transacted in her account, this argument fails for several reasons. First, as discussed more fully below, there is a lack of credible evidence to support the assertion that Lowry made such a demand.[40] Second, even if she did make the demand, Murphy has completely failed to show why his uncovered options trades were necessary to meet such a demand. Finally, Lowry's alleged demand for a particular investment outcome does not mean that Murphy was permitted to pursue unauthorized trades in pursuit of that goal. As the NAC decision concluded, "[i]f Murphy was unable to meet any purported

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[38] NAC Appeal Br. of Appellants-Resp'ts at 18.

[39] *Id.*

[40] *See infra* at 19-20.

income demands employing only covered calls, that did not give him the authorization—either from [Lowry] or [BIS]—to effect uncovered options trades."[41]

Murphy further argues that, despite "frequent contact" with him, "Lowry never expressed a concern about the type of options transactions effected" in her account.[42] But the fact that Lowry did not complain about the uncovered option positions in her account does not mean that Murphy's trading was authorized. Lowry believed that Murphy was pursuing only a covered call strategy, and she lacked the sophistication to understand that Murphy was, in fact, significantly deviating from that strategy. Moreover, even if Lowry's apparent acquiescence were viewed as ratification of Murphy's uncovered options trades, "we have held repeatedly that after-the-fact 'acceptance' of an unauthorized trade does not transform that transaction into an authorized trade."[43] And, as FINRA recognized, given Lowry's lack of investment experience and Murphy's repeated false assurances that her account was profitable, any absence or delay in complaints from Lowry was most likely "a consequence of misplaced trust" in Murphy, "rather than approval of his actions."[44]

C. Murphy's conduct involved unsuitable recommendations, excessive trading, and churning.

NASD Rule 2310, known as the suitability rule, requires that "[i]n recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." A registered representative can violate the suitability rule if he or she "inadequately assesses whether the recommendation is suitable for the 'specific investor to whom the recommendation is directed'" (customer-specific unsuitability), or if "the level of trading recommended by the representative is excessive in light of the customer's investment needs and objectives" (quantitative unsuitability).[45] FINRA found that Murphy violated customer-specific suitability requirements by his options trading in Lowry's account and violated quantitative suitability requirements by engaging in excessive trading in both Lowry's and Martinelli's accounts. In addition, FINRA found that Murphy churned Lowry's and Martinelli's

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[41] *Murphy*, 2011 WL 5056463, at *11.

[42] NAC Appeal Br. of Appellants-Resp'ts at 17-18.

[43] *Sandra K. Simpson*, Exchange Act Release No. 45923, 55 SEC 766, 2002 WL 987555, at *13 (May 14, 2002); *see also Edgar B. Alacan*, Exchange Act Release No. 49970, 57 SEC 715, 2004 WL 1496843, at *6 n.27 (July 6, 2004); *Katz*, 2010 WL 358737, at *22 ("[R]atification of a transaction after the fact does not establish that trades were authorized before being executed.").

[44] *See Alacan*, 2004 WL 1496843, at *6 n.27.

[45] *Cody*, 2011 WL 2098202, at *9 (quoting *F.J. Kaufman & Co. of Va.*, Exchange Act Release No. 27535, 50 SEC 164, 1989 WL 259961, at *3 (Dec. 13, 1989)).

accounts in violation of FINRA rules[46] and antifraud provisions of the securities laws.[47] We sustain FINRA's findings on each of these violations.

1. Murphy's options trading in Lowry's account violated customer-specific suitability requirements.

We have held that "[i]nvestment recommendations must be suitable for the investor when evaluated in terms of the investor's financial situation, tolerance for risk, and investment objectives."[48] Because options trading involves heightened risk, before recommending "an opening transaction in any option contract" a registered representative must have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he [or she] may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract."[49]

Lowry was an unsophisticated investor with a limited understanding of options. When opening her account, she indicated that her tolerance for risk was moderate and that her primary objectives were income and long-term growth. Lowry had considerable assets—notably her shares of P&G stock—but she was also dependent on her P&G stock as her primary source of income. Upon a recommendation from a friend, she asked Jage, and later Murphy, to pursue a covered call strategy as a way to supplement the income she received from P&G dividends. Although a covered call strategy is considered a relatively conservative options strategy,[50] it is not clear from her testimony that Lowry properly understood what that strategy entailed or the attendant risks. In addition to having only a basic understanding of options, it appears that Lowry did not understand that her insistence that her P&G stock not get called away had the

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[46] FINRA found that, in addition to violating NASD Rule 2310, which prohibits excessive trading as a violation of suitability obligations, Murphy violated NASD Rule 2120, which prohibits registered representatives from "effect[ing] any transaction in, or induc[ing] the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

[47] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

[48] *Simpson*, 2002 WL 987555, at *14; *see also Katz*, 2010 WL 358737, at *20 ("A registered representative is obligated to make 'a customer-specific determination of suitability and to tailor his recommendations to the customer's financial profile and investment objectives.'" (quoting *F.J. Kaufman & Co. of Va.*, 1989 WL 259961, at *3)).

[49] NASD Rule 2860(b)(19)(B). Additionally, before recommending any options transaction, a registered representative must conduct a "reasonable inquiry . . . concerning the customer's investment objectives, financial situation and needs." NASD Rule 2860(b)(19)(A).

[50] *Michael E. Tennenbaum*, Exchange Act Release No. 18429, 47 SEC 703, 1982 WL 31984, at *2 n.6 (Jan. 19, 1982) ("Covered writing involves the sale of options against stock already owned, and is considered a relatively conservative strategy."); Poser, *supra* note 3, at 589 ("Covered call writing is generally considered to be a conservative strategy.").

potential to undermine her goal of income generation, because the need to buy back options could lead, in the words of FINRA's expert witness, to a "severe cash drain."[51]

Because Murphy's trading strayed considerably from a covered call strategy, in order to find that Murphy violated customer-specific suitability requirements, we, like the NAC, need not reach the question whether a covered call strategy combined with Lowry's direction to preserve her P&G stock was *per se* unsuitable. Even if the strategy was not *per se* unsuitable under the circumstances, and even if Lowry had understood and was financially able to bear the risks associated with the covered call strategy she requested, Murphy did not limit his trading to this strategy. Instead, Murphy's trading in Lowry's account included writing numerous uncovered or naked calls as well as uncovered puts. Unlike writing covered calls, where the potential for loss is limited by the fact that the option writer holds the underlying security necessary to satisfy the option obligation, the sale of uncovered calls entails substantial risks because it "may theoretically involve unlimited losses."[52] Likewise, writing uncovered puts is extremely risky because the writer may be obligated to buy a security at an exercise price that is far greater than the security is worth.[53] In addition to uncovered options, Murphy's trading involved complex option combinations, which involve buying or selling both puts and calls and are by their nature more complex than other options transactions. Trading in uncovered options and combinations was highly risky and was unsuitable for Lowry, an investor with only moderate risk tolerance and limited understanding of and experience with options.[54]

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[51] Ex. CX-37, at 4.

[52] *Ronald L. Brownlow*, Exchange Act Release No. 18257, 47 SEC 662, 1981 WL 28137, at *2 n.2 (Nov. 16, 1981) (citing U.S. Securities and Exchange Commission, 96th Cong., 1st Sess., Report of the Special Study of the Options Markets, 114 (Comm. Print 1978) [hereinafter Special Study]); *see also id.* at *2 ("[N]aked call options . . . are highly speculative investments" because a "customer might have to purchase (1) the underlying securities covered by the option at a price greater than the premium received and the exercise price, or, in order to protect himself, (2) an option similar to the one sold for more than the premium he obtained."); *Clyde J. Bruff*, Exchange Act Release No. 31141, 50 SEC 1266, 1992 WL 224091, at * 4 & n.19 (Sept. 3, 1992) ("Since the writer does not own the underlying security represented by a 'naked' option, he is subject to high degree of loss."); *Thomas P. Garrity*, Exchange Act Release No. 25115, 48 SEC 880, 1987 WL 755334, at *1 & n.3 (Nov. 12, 1987) (noting that "writ[ing] uncovered or 'naked' call options" is "a very risky strategy" because "uncovered call writing may result in very substantial losses if the market price of the stock underlying the call continues to rise above the exercise price of the call").

[53] *See* Special Study, *supra* note 53, at 114 (the writer of an uncovered put faces a potential "loss which is limited only by the exercise price").

[54] *See Frank DeRose*, Exchange Act Release No. 32812, 51 SEC 652, 1993 WL 328418, at *5-6 (Aug. 26, 1993) (broker's options trading was unsuitable for his customers who expressed a low tolerance for risk and "were unsophisticated investors with little experience in financial matters and even less knowledge of options"); *Patrick G. Keel*, Exchange Act Release No. 31716, 51 SEC 282, 1993 WL 12348, at *2 (Jan. 11, 1993) (registered representative's recommendation of risky options trading was unsuitable for an unsophisticated investor who sought long-term growth and desired to retain her principal); *Ivan M. Kobey*, Exchange Act Release No. 31630, 51 SEC 204, 1992 WL 394557, at *7 (Dec. 22, 1992) (trading "in risky option strategies, including taking positions in naked options" was "entirely unsuitable" for customers "with conservative, growth-oriented objectives" and very limited investment experience); *Bruff*, 1992 WL 224091, at *3-4 (registered representative's recommendations for "highly aggressive options trading" that "involved a high degree of financial risk and complexity" were unsuitable for

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Furthermore, Murphy's extensive trading on margin in Lowry's account (with the margin debit balance reaching as high as $1.16 million on July 31, 2005) made his risky options trading even riskier and, therefore, even less suitable for Lowry. We have frequently held that trading on margin increases the risk of loss to a customer.[55] Not only does the use of margin mean that a customer is "at risk to lose more than the amount invested if the value of the securities depreciates sufficiently," but "[t]he customer is also required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his or her investment must appreciate before the customer realizes a net gain."[56] The large margin debit balance in Lowry's account exacerbated the unsuitability of Murphy's already risky trading.[57]

Murphy suggests that, if his trading were unsuitable, others who received information about the account, such as Pesavento and DeRose, would have expressed concerns. This argument is without merit. DeRose raised concerns to Birkelbach, saying that she thought the activity in Lowry's account was unusually high. Furthermore, because neither Pesavento nor DeRose had the responsibility to assess the suitability of Murphy's trading and neither had expertise in options trading, there is no reasonable basis for Murphy to have expected them to raise concerns about the trades' suitability. Moreover, as we have held previously, "applicants cannot shift to others the responsibility for their own compliance with applicable rules."[58]

Given Lowry's lack of investment knowledge and experience and her moderate tolerance for risk, Murphy's trading in Lowry's account, which involved highly risky options transactions and extensive trading on margin, was wholly unsuitable for his customer. Accordingly, we sustain FINRA's finding that Murphy violated customer-specific suitability requirements with regard to his trading in Lowry's account.

(...continued)
customers who, *inter alia*, lacked experience with and understanding of options trading); *see also* Poser, *supra* note 3, at 593 ("[T]he complexity of the options strategy used in a customer's account is a factor in ascertaining whether or not the trading in the account was consistent with the customer's investment objectives and financial needs. A strategy that is incomprehensible to an investor can hardly be regarded as suitable for him. As the literature of the options exchanges states, 'a complexity not well understood is, in itself, a risk factor.'" (quoting American Stock Exchange, Inc., et al., *Understanding the Risks and Uses of Listed Options* 30 (1982))).

[55] *See, e.g.*, *Luis Miguel Cespedes*, Exchange Act Release No. 59404, 2009 WL 367026, at *7 (Feb. 13, 2009).

[56] *Id.*; *see also Alacan*, 2004 WL 1496843, at *9 & n.54 (noting that margin trading increased the risks to customers).

[57] *James B. Chase*, Exchange Act Release No. 47476, 56 SEC 149, 2003 WL 917974, at *4 (Mar. 10, 2003) (finding that trading on margin increased the unsuitability of already risky trading); *Jack H. Stein*, Exchange Act Release No. 47335, 56 SEC 108, 2003 WL 431870, at *3 & n.15 (Feb. 10, 2003) (same); *David A. Gingras*, Exchange Act Release No. 31206, 50 SEC 1286, 1992 WL 280780, at *3 (Sept. 21, 1992) (same).

[58] *John Edwards Mullins*, Exchange Act Release No. 66373, 2012 WL 423413, at *13 (Feb. 10, 2012).

2. Murphy engaged in excessive trading in Lowry's and Martinelli's accounts.

Murphy also violated suitability requirements by engaging in excessive trading.[59] "Excessive trading occurs when a registered representative has control over the trading in an account and the level of trading in that account is inconsistent with the customer's objectives and financial situation."[60] A registered representative's control over an account "may be established when the customer relies on the representative such that the representative controls the volume and frequency of transactions."[61] Thus, a registered representative's exercise of *de facto* discretionary control over a client's account (even if the exercise of discretion is not properly authorized) satisfies the element of control for the purpose of demonstrating excessive trading.[62] As we previously found, Murphy exercised discretionary control in both Lowry's and Martinelli's accounts, and thus had the requisite control over the trading in these accounts to establish an excessive trading violation.

Murphy's trading in Lowry's account was excessive. Almost immediately after taking over the management of Lowry's account from Jage, Murphy began frequently trading large volumes of option contracts. For the three-and-a-half years he managed Lowry's account, Murphy engaged in over 2,500 options transactions involving more than 67,000 option contracts. This trading reached its peak between November 2004 and January 2006, when Murphy traded between 4,000 and 8,000 option contracts per month. Because Murphy traded almost exclusively option contracts in Lowry's account, a relevant gauge of excessive trading is the cost-to-equity ratio, *i.e.*, the percentage the account would have to appreciate just to break even.[63] Although "our assessment of whether trading is excessive does not rest on any magical per

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[59] *See Harry Gliksman*, Exchange Act Release No. 42255, 54 SEC 471, 1999 WL 1211765, at *2 (Dec. 20, 1999) ("[R]ecommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."), *aff'd*, 24 F. App'x 702 (9th Cir. 2001) (unpublished); *John M. Reynolds*, Exchange Act Release No. 30036, 50 SEC 805, 1991 WL 288500, at *2 (Dec. 4, 1991) ("Excessive trading may be thought of as quantitative unsuitability.").

[60] *Cody*, 2011 WL 2098202, at *12 (citing *Gliksman*, 1999 WL 1211765, at *2).

[61] *Id.* (citing *Clyde J. Bruff*, Exchange Act Release No. 40583, 53 SEC 880, 1998 WL 730586, at *2 (Oct. 21, 1998), *Stephen Thorlief Rangen*, Exchange Act Release No. 38486, 52 SEC 1304, 1997 WL 163991, at *4 (Apr. 8, 1997), and *Reynolds*, 1991 WL 288500, at *2).

[62] *See Frederick C. Heller*, Exchange Act Release No. 31696, 51 SEC 275, 1993 WL 8588, at *2 & n.7 (Jan. 7, 1993) (finding "control" when a registered representative "exercised *de facto* discretionary control" over customers' account, as evidenced by the fact that customers "were not consulted, nor typically even made aware of, the particular trades executed in their account until well after the fact.").

[63] *See* Special Study, *supra* note 53, at 451-55 (noting that conventional turnover rate formulas do not adequately measure "the impact of options trading on the activity in customer accounts since they completely ignore the effect of the sale of options contracts" and that a cost-to-equity ratio is a "logical solution to the need for a standard formula to measure trading activity in customer accounts which include options"); *cf. Eugene J. Erdos*, Exchange Act Release No. 20376, 47 SEC 985, 1983 WL 33908, at *4 n.14 (1983) (citing the Special Study in rejecting the use of the turnover rate for measuring excessive trading in an options account).

annum percentage,"[64] we have held that "a cost-to-equity ratio in excess of 20% generally indicates that excessive trading has occurred."[65] During Murphy's management of the account, the annualized cost-to-equity ratio was 25.59% (22.75% excluding margin interest). And looking separately at 2004 and 2005, the cost-to-equity ratios were even higher—31.25% for 2004 and 48.56% for 2005.[66] Another indication of excessive trading is the fact that Murphy's trading frequently involved multiple round-trip transactions for the same option series, meaning that Murphy sold and bought back the same option series repeatedly.[67] Under the circumstances, we agree with FINRA that Murphy's trading in Lowry's account was excessive.

Murphy contends the amount of trading in Lowry's account was "necessitated" by Lowry's demand that the account generate $10,000 per month in income.[68] To meet this demand, Murphy suggests that he had to engage in heavy and frequent trading. But there is a lack of credible evidence that Lowry directed Murphy to generate $10,000 per month in income. Murphy testified to this effect, but the hearing panel found that Murphy generally was not credible.[69] For her part, Lowry testified before the hearing panel that she never made such a demand. Murphy argues that the hearing panel did not give sufficient weight to a document prepared for Lowry by her financial planner Karen DeRose, which Murphy asserts impeaches Lowry's testimony. But the document is not persuasive impeachment evidence. Prepared by DeRose in April 2004, the document summarizes a discussion between DeRose and Lowry concerning the latter's financial plans. Under the heading "Retirement Planning," the document states: "You want to be financially independent with annual income of 120,000, adjusting for

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[64] *Cody*, 2011 WL 2098202, at *14 (quoting *Gerald E. Donnelly*, Exchange Act Release No. 36690, 52 SEC 600, 1996 WL 20843, at *2 (Jan. 5, 1996)) (internal quotation marks omitted); *see also Stein*, 2003 WL 431870, at *4 (noting that "there is no single test for making an excessive trading determination").

[65] *Daniel Richard Howard*, Exchange Act Release No. 46269, 55 SEC 1096, 2002 WL 1729157, at *3 (July 26, 2002); *see also Rafael Pinchas*, Exchange Act Release No. 41816, 54 SEC 331, 1999 WL 680044, at *5 (Sept. 1, 1999) ("We have previously found that a cost-to-equity ratio in excess of 20% indicates excessive trading."); *Gliksman*, 1999 WL 1211765, at *3-4 (finding excessive trading in the account of a conservative corporate investor with an annualized cost-to-equity ratio of 18%); *Peter C. Bucchieri*, Exchange Act Release No. 37218, 52 SEC 800, 1996 WL 254677, at *2-4 (May 14, 1996) (finding excessive trading in account with cost-to-equity ratios of 21% to 30%).

[66] Excluding margin interest, the cost-to-equity ratios were 27.78% in 2004 and 39.32% in 2005.

[67] *Cf. Bruff*, 1992 WL 224091, at *4 (finding options trading unsuitable that was "highly aggressive" and included, *inter alia*, "frequent transactions where positions were opened and closed within short periods of time").

[68] NAC Appeal Br. of Appellants-Resp'ts at 14, 16.

[69] We have frequently held that "'the credibility determination of the initial decisionmaker is entitled to considerable weight and deference, since it is based on hearing the witnesses' testimony and observing their demeanor'" and that "'without substantial evidence in the record to the contrary, we cannot depart from the fact finder's determination of credibility.'" *Sears*, 2008 WL 2597567, at *2 (quoting *Jon R. Butzen*, Exchange Act Release No. 36512, 52 SEC 512, 1995 WL 699189, at *2 n.7 (Nov. 27, 1995) and *Fu-Sung Peter Wu*, Exchange Act Release No. 45694, 55 SEC 737, 2002 WL 507009, at *5 n.22 (Apr. 4, 2002)). We find no basis to disturb the hearing panel's credibility determination here.

inflation until age 95."[70] Contrary to Murphy's contention, the fact that Lowry told DeRose that the goal for her future retirement was to have $120,000 in income per year does not mean that Lowry demanded $10,000 per month from Murphy during the time he managed her account. The weight of the relevant evidence does not support Murphy's contention that Lowry made such a demand.

Moreover, even if Lowry had insisted that Murphy generate $10,000 in monthly income, Murphy has not adequately explained how his excessive options trading was likely to further that objective. Notably, Murphy's options trading, rather than generating income, consistently lost money for Lowry. And although Murphy points to the testimony of his two expert witnesses to argue for the "difficulties" of the task he faced,[71] no coherent explanation of his excessive trading can be found in either expert's testimony. Indeed, Murphy's trading frequently resulted in option positions that defied any rational explanation. As FINRA's expert testified concerning one set of positions in Lowry's account, "if this looks like spaghetti . . . it's because it is."[72] Murphy himself was unable to explain to the hearing panel how similar positions held in Lowry's account in late 2002 would lead to profits. But even if Murphy could explain how his trading was intended to meet Lowry's alleged demand for income—which he has not done—Murphy offers no explanation for how his aggressive trading of highly risky options was compatible with Lowry's moderate risk tolerance. A request from Lowry for $10,000 in monthly income would not permit Murphy to pursue trading that was wholly unsuitable in light of his customer's financial profile.[73]

Murphy also argues that FINRA's excessive trading and suitability analysis does not account for the increased value of Lowry's P&G stock, which "mitigated" the account's losses.[74] But the fact that Murphy's excessive options trading did not result in as great a loss to Lowry as it could have does not mean that it was suitable for her.[75] Indeed, it is only because the value of Lowry's P&G stock appreciated significantly (something over which Murphy had no control) that the cost-to-equity ratio in the account was not significantly higher. Regardless of the

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[70] Ex. RX-58.

[71] NAC Appeal Br. of Appellants-Resp'ts at 15.

[72] Tr. at 625.

[73] *See Pinchas*, 1999 WL 680044, at *6 ("[E]ven if [his customer] desired Pinchas to double her money, that desire would not have relieved Pinchas from his duty to recommend only those trades suitable to her situation.").

[74] NAC Appeal Br. of Appellants-Resp'ts at 15; *see also id.* at 2.

[75] *See Stein*, 2003 WL 431870, at *4 n.21 ("Unsuitable recommendations . . . do not become suitable because they result in a profit."); *cf. also Michael T. Studer*, Exchange Act Release No. 50543A, 57 SEC 1011, 2004 WL 2735433, at *5 (Nov. 30, 2004) ("The existence of churning does not turn on whether the customer lost money. The effect of churning is to reduce the customer's return on her investment by increasing the commissions generated by the account. An account may be churned even if the customer shows a profit on the excessive trading. To maintain otherwise would mean that 'securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested.'" (footnotes omitted) (quoting *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1218 (8th Cir. 1990)), *aff'd*, 148 F. App'x 58 (2d Cir. 2005)).

appreciation in the value of Lowry's P&G stock, we find that Murphy's options trading in Lowry's account was excessive and unsuitable.

Murphy's trading in Martinelli's account was also excessive. Martinelli was an investor of modest means who, during the time Langlois managed his account, had seen significant account appreciation from investments primarily in low-priced securities. When Murphy took over the account from Langlois, Murphy told Martinelli that he would like to pursue a "more conservative" approach.[76] Despite the fact that Martinelli never authorized him to trade, Murphy almost immediately began actively trading, increasing the volume of trading in the account dramatically. In the three months he managed the account, Murphy liquidated nearly all of Martinelli's holdings and made numerous trades in a variety of stocks, including several instances of in-and-out trading. This trading resulted in an annualized turnover rate of 22.62[77] and an annualized cost-to-equity ratio of 169%. These calculations represent a level of trading substantially above that found to support excessive trading in other cases.[78] Even if it could be argued that Martinelli had a reasonably high tolerance for risk,[79] the extremely high turnover rate and cost-to-equity ratio tend to show a level of trading that is unsuitable in the circumstances.[80] In addition, the multiple in-and-out trades effected by Murphy in the account in a short period of time are a "hallmark of excessive trading."[81]

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[76] Tr. at 55.

[77] FINRA calculated the turnover rate using the modified Looper formula, which involves dividing the total cost of purchases by average monthly investment or equity, and then annualizing the result. *See Stein*, 2003 WL 431870, at *4 n.26.

[78] *See Howard*, 2002 WL 1729157, at *3 ("While there is no definitive turnover rate or cost-to-equity ratio that establishes excessive trading, a turnover rate of 6 or a cost-to-equity ratio in excessive of 20% generally indicates that excessive trading has occurred."); *Gliksman*, 1999 WL 1211765, at *4 (noting that a turnover "rate in excess of 6 is generally presumed to reflect excessive trading" and finding that annualized turnover rate of 12.28 and cost-to-equity ratio of 18% demonstrated excessive trading for a conservative investor); *Pinchas*, 1999 WL 680044, at *5 (finding excessive trading in accounts with annualized turnover rates of 16.63 and 21.04 and cost-to-equity ratios of 110% and 61%); *Al Rizek*, Exchange Act Release No. 41725, 54 SEC 261, 1999 WL 600427, at *5 (Aug. 11, 1999) (noting that a turnover "rate in excess of 6 is generally presumed to reflect excessive trading" and finding that turnover rates ranging from 13.6 to 19.8 and cost-to-equity ratios ranging from 33% to 52% demonstrated excessive trading for accounts with conservative investment objectives); *Bucchieri*, 1996 WL 254677, at *4 (finding excessive trading in accounts with annualized turnover rates of 7.2 to 13.6 and cost-to-equity ratios of 21% to 30%).

[79] Martinelli's new account documentation from 1999 indicated a risk exposure level of "speculation," but it is unclear whether that was the case when Murphy took over the account in 2007. There is no indication that Murphy made any inquiry regarding Martinelli's risk tolerance. As FINRA points out, likely the best gauge for Martinelli's risk tolerance at the time Murphy took over the account was Martinelli's statement that he thought a "more conservative" approach made sense.

[80] *Cf. Henry James Faragalli, Jr.*, Exchange Act Release No. 37991, 52 SEC 1132, 1996 WL 683707, at *6 (Nov. 26, 1996) (finding excessive trading in an account with an annualized turnover rate of 15.4 and cost-to-equity ratio of 42.9% where customer sought 10% to 15% annual returns and was "willing to accept a reasonable degree of risk").

[81] *Cody*, 2011 WL 2098202, at *13 (quoting *Howard*, 2002 WL 1729157, at *3).

Murphy argues that FINRA's use of a 169% cost-to-equity ratio is unfair because it includes costs associated with Murphy's initial reallocation of Martinelli's portfolio. But, like FINRA, we see no basis to exclude these costs, particularly because Martinelli never authorized Murphy to reallocate his portfolio. And as FINRA states, even if the commissions from Murphy's reallocation in April 2007 were excluded, the annualized cost-to-equity ratio would still be 102%—more than sufficient to support a finding of excessive trading.

Murphy also contends that the amount of time he managed the account was too short to obtain meaningful annualized measures of his trading activity. We disagree. We have often evaluated relatively short periods of time in the life of accounts to determine whether excessive trading has occurred.[82] In this context, we have noted that "the period to use to determine whether an account has been excessively traded" is simply "the period during which the allegedly excessive trading occurred."[83] While there may be limitations on the usefulness of annualized turnover rates and cost-to-equity ratios to evaluate trading for particularly short time periods, we agree with FINRA that the three months of trading here does not qualify as "particularly short" and that the turnover rate and cost-to-equity ratio are so high that they support a finding of excessive trading for the time period at issue.[84] For these reasons, we sustain FINRA's finding that Murphy's trading in Martinelli's account was quantitatively unsuitable.

3. Murphy churned Lowry's and Martinelli's accounts.

We also sustain FINRA's finding that Murphy churned Lowry's and Martinelli's accounts. "'Churning occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interests.'"[85] In addition to the two elements that are necessary to find excessive trading—control and trading that is excessive in light of the customer's investment objectives—churning requires a third element of scienter on the part of the broker.[86] Scienter "is established either by evidence of intent to defraud or by evidence of willful and reckless disregard of the customer's interests."[87]

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[82] *See, e.g.*, *Simpson*, 2002 WL 987555, at *14 n.45 (rejecting argument that measuring account activity for six months resulted in artificially high value for the annualized turnover rate and cost-to-equity ratio); *Laurie Jones Canady*, Exchange Act Release No. 41250, 54 SEC 65, 1999 WL 183600, at *6 (Apr. 5, 1999) (rejecting argument that measuring account activity for nine months was too short a period of time to support a finding of excessive trading); *Bucchieri*, 1996 WL 254677, at *2-4 (finding excessive trading based on a review period of eight months).

[83] *Simpson*, 2002 WL 987555, at *14 n.45.

[84] *See Dep't of Enforcement v. O'Hare*, Complaint No. C9B030045, 2005 WL 1002949, at *4 (NAC Apr. 20, 2005) (finding excessive trading based on a three-month period of trading with an annualized cost-to-equity ratio of 140% and an annualized turnover rate of 21.358).

[85] *Studer*, 2004 WL 2735433, at *4 (quoting *Donald A. Roche*, Exchange Act Release No. 38742, 53 SEC 16, 1997 WL 328870, at *4 (June 17, 1997)); *see also Rizek*, 1999 WL 600427, at *5 ("Churning occurs 'when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions.'" (quoting *Olson v. E.F. Hutton & Co.*, 957 F.2d 622, 628 (8th Cir. 1992))).

[86] *Roche*, 1997 WL 328870, at *4 ("Scienter . . . is what separates 'churning' from 'excessive trading.'").

(continued...)

FINRA found that the evidence in the record demonstrated that Murphy's trading in Lowry's account was for the purpose of generating commissions and was carried out with reckless disregard of Lowry's interests. We agree. During the time Murphy managed Lowry's account, Murphy's trading generated over $1 million in commissions, with a majority of those commissions going directly to Murphy. From the third quarter of 2002 through the end of 2005, Murphy's trading in Lowry's account was responsible for 59% of his total commissions. Given the very high level of commissions and the resulting high cost-to-equity ratio in the account, the evidence in the record supports the finding that Murphy's overriding goal was generating commissions.[88] The volume and frequency of Murphy's options trading—including repeated round-trip trades—is difficult to explain except as Murphy's seeking to maximize his own commissions in disregard of Lowry's interests.[89] And although Lowry had only a moderate tolerance for risk and limited experience with and knowledge of options trading, Murphy abused the trust she had placed in him and engaged in excessive options trading inconsistent with her interests.[90] As FINRA's expert concluded in his report, Murphy's "trading was inappropriate, unnecessarily frequent, of a speculative nature and the only beneficiary was the recipient of the all too high transaction fees."[91]

Further evidence of scienter comes from Murphy's attempts to mislead Lowry about his trading.[92] On more than one occasion, Lowry raised concerns with Murphy about the trading losses and the level of commissions in her account only to be misled by Murphy's false assurances that she was "making money" and that commissions "didn't matter."[93]

Murphy argues that it would have been illogical to send duplicate account statements to Lowry's accountants and financial planner if he had intended to defraud her. But duplicate account statements were not sent to Lowry's accountants and financial planner during one of the most active periods in the account—between April 2003 and April 2005. And the fact that

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(...continued)
Although the terms "churning" and "excessive trading" have sometimes been used interchangeably, "churning" is "the violation's normal designation in a fraud context." *Id.* "'Excessive trading,' without more, is a type of violation of broad 'suitability' rules promulgated by self-regulatory organizations, which are not antifraud provisions." *Id.*

87 *Rizek*, 1999 WL 600427, at *5; *see also Studer*, 2004 WL 2735433, at *4-5; *Roche*, 1997 WL 328870, at *4.

88 *See Studer*, 2004 WL 2725433, at *5 ("The generation of commissions as a goal overriding the client's interests evidences scienter in churning.").

89 *See Roche*, 1997 WL 328870, at *4 (the motivation to maximize a broker's remuneration in disregard of the interests of the customer "creates the element of scienter necessary for a violation of the antifraud provisions of the securities laws").

90 *See Rizek*, 1999 WL 600427, at *6 (pursuing a riskier strategy than appropriate for a customer can be evidence of scienter).

91 Ex. CX-37, at 14.

92 *See, e.g.*, *Phillip J. Milligan*, Exchange Act Release No. 61790, 2010 WL 1143088, at *5 (Mar. 26, 2010) ("[A]ttempts to conceal misconduct indicate scienter.").

93 Tr. at 148.

others received account statements does not preclude a finding of scienter. There is no evidence that Lowry's accountants and financial planner were tasked with monitoring the account or that Lowry told Murphy that they were. Even if Murphy believed there was an increased risk that Pesavento or DeRose might raise objections about the level of his trading, this is not inconsistent with the finding that he acted with scienter.

We also agree with FINRA that Murphy acted with scienter in excessively trading Martinelli's account. Given the 169% cost-to-equity ratio and turnover rate of 22, Murphy must have known that his trading was wholly inconsistent with his customer's interests. Murphy's so-called "conservative approach" resulted in Martinelli's account value decreasing by more than 45% in just two months. The approximately $5,400 in commissions Murphy generated in Martinelli's account in the three months he managed it represented 42% of Martinelli's average equity and nearly 17% of Martinelli's annual salary. These facts support the finding that Murphy was acting with the purpose of generating commissions and in reckless disregard of Martinelli's interest.

In light of the above, we find that Murphy acted with scienter and churned both Lowry's and Martinelli's accounts.

D. Murphy distributed misleading communications to Lowry.

FINRA found that Murphy caused the creation and distribution to Lowry of inaccurate, misleading, and unbalanced written communications, in violation of NASD Rules 2210, 2220, and 2110. Rule 2210(d)(1) provides, in relevant part, as follows:

> (A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.
>
> (B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

Similarly, Rule 2220(d)(1), governing content standards for communications with the public concerning options, provides that

> [n]o member . . . or person associated with a member shall utilize any advertisement, educational material, sales literature or other communications to

> any customer or member of the public concerning options which . . . contains any untrue statement or omission of a material fact or is otherwise false or misleading.

FINRA identified three types of written communications that Murphy caused to be created and sent to Lowry in violation of these rules: profit-and-loss reports (periodic reports detailing the realized profits and losses from the options trading in the account), the change-in-account-value report (purporting to show overall change in the value of Lowry's account between 2002 and 2005), and a document titled, "Safe Option Strategies that can be employed" (a one-page document describing potential option strategies).

Murphy testified that these communications were created under his direction and sent to Lowry at his request. Each type of communication contained untrue statements of material fact or was otherwise false or misleading. Specifically, the profit-and-loss statements sent to Lowry were filled with errors concerning the profits in Lowry's account. Twelve of the sixteen statements overstated the account's total profits—one by over $38,000—and the reports contained multiple errors on a line-by-line basis that contributed to the errors in the profit totals. Similarly, the change-in-account-value report, which purported to show the change in the value of the account for each year between 2001 and 2005, contained numerous errors. Because it calculated the changes in the account's value in an inconsistent manner, the report significantly misstated the change in the value of the account for the years 2003 to 2005. The resulting errors were sizable: for 2003, the report indicated the account value increased $276,316, when in fact it decreased $7,738; for 2004, the report indicated the account value decreased $384,465, when in fact it decreased $1,136,736; and for 2005, the report indicated the account value increased by $256,031, when in fact it increased by $537,502.

These errors were material, as reasonable investors would consider information concerning the profits, losses, and value of their accounts important in making investment decisions.[94] Murphy testified that he reviewed the profit-and-loss statements and the change-in-account-value report before they were sent to Lowry. Under the circumstances, given the size and frequency of the errors in these communications, we agree with FINRA that Murphy knew or had reason to know they contained material misstatements.

The "Safe Option Strategies" document was also materially misleading and unbalanced because it failed to identify the substantial risks associated with the option strategies it described and inaccurately described such strategies as "safe." Specifically, the document identified a "collar option" and a "short straddle" as safe strategies and highlighted their objectives and upsides. But the document failed to mention that the strategies described involved the risk of substantial losses should the value of the underlying security change significantly. As someone

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[94] *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (materiality depends upon whether there is a substantial likelihood that a reasonable investor would have considered the misstated or omitted fact important in making an investment decision).

with experience in options, Murphy knew or had reason to know that the document was misleading.

Murphy does not dispute that the identified communications sent to Lowry contained untrue statements of material fact or that they were misleading and unbalanced. Instead, he argues these communications did not violate FINRA rules because they were not "sales literature." Murphy argues that information sent to a single customer does not qualify as "sales literature" pursuant to NASD Rule 2210. But the rules FINRA found Murphy to have violated are not limited to "sales literature." Rule 2210(d)(1) applies to "[a]ll member communications with the public," including "correspondence."[95] "Correspondence," in turn, was defined prior to November 2003 to include "any written or electronic communication prepared for delivery to a single current or prospective customer," and after November 2003 to include "any written letter or electronic mail message distributed by a member to . . . one or more of its existing retail customers."[96] The relevant communications sent to Lowry qualify as "correspondence" under either definition. Similarly, Rule 2220(d)(1) applies to "any advertisement, educational material, sales literature *or other communications to any customer* or member of the public concerning options" (emphasis added). Thus, contrary to Murphy's suggestion, all of the communications identified above come within the scope of Rules 2210(d) and 2220(d)(1).

Accordingly, we sustain FINRA's finding that Murphy violated NASD Rules 2210, 2220, and 2110 by causing inaccurate, misleading and unbalanced communications to be sent to Lowry.

E. Birkelbach failed to reasonably supervise Murphy.

NASD Rule 3010(a) requires that a member "establish and maintain" a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [NASD Rules]." In addition, NASD Rule 2860(b)(20) requires that members provide for the "diligent supervision" of options trading in customer accounts and implement procedures providing for "frequent supervisory review" of "customer accounts maintaining uncovered short option positions." Whether a supervisor's actions constitute "reasonable" supervision "'is determined based on the particular circumstances of each case.'"[97] We have held that "'[t]he duty of supervision includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation.'"[98] "'Once indications of irregularity arise, supervisors must respond

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[95] *See* NASD Rule 2210(a)(3).

[96] *Compare* NASD Rule 2210(a)(3) (2002) *with* NASD Rules 2210(a)(3) (2006 NASD Manual) *and* 2211(a)(1)(A) (2006 NASD Manual).

[97] *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *10 (Dec. 19, 2008) (quoting *John A. Chepak*, Exchange Act Release No. 42356, 54 SEC 502, 2000 WL 49226, at *6 n.27 (Jan. 24, 2000)).

[98] *Id.* (quoting *Studer*, 2004 WL 2725433, at *6).

appropriately.'"[99] "'[R]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the securities laws.'"[100]

As the Senior Registered Options Principal, Birkelbach had supervisory responsibilities over Murphy's options trading during the time Murphy managed Lowry's account. Birkelbach was familiar with Lowry's account—he approved the opening of Lowry's option account as well as the subsequent changes to the option agreement allowing uncovered writing and spreading. He was also familiar with the trading that occurred in the account because he reviewed all options trades and reviewed accounts to see if options trading was within approved levels.

From this vantage point, Birkelbach was presented with numerous red flags associated with Murphy's trading in Lowry's account. To begin with, Birkelbach should have been concerned with the dramatic increase in trading activity that occurred when Murphy took over the account from Jage. Murphy's heavy trading continued unabated for several years as commissions, trading losses, and margin debt grew. Birkelbach admitted during the hearing that he knew there was "a lot of activity" in Lowry's account and that the increase in commissions was "obvious."[101] Birkelbach should also have been concerned that Murphy's trading—involving uncovered options and complex combinations—was highly risky and exceeded the levels approved for the account. The parties stipulated that Birkelbach knew that Murphy effected uncovered options transactions from August 2002 through October 2004 in Lowry's account. And Birkelbach should have known that such trading was unsuitable for a customer like Lowry, who was an unsophisticated investor with only moderate tolerance for risk. Indeed, he conceded as much to FINRA investigators by stating that an investor's objectives should be "speculative or high risk" to trade uncovered options.[102]

In the face of these red flags, Birkelbach failed to exercise appropriate supervision over Murphy's handling of Lowry's account. Under the circumstances, an appropriate supervisory response at a minimum would have included a further investigation into Murphy's trading in Lowry's account and, when violations were detected, corrective actions to prevent future misconduct. Instead, Birkelbach allowed Murphy to churn Lowry's account for years while he took no meaningful action—never disapproving any trade made in Lowry's account and never questioning Murphy about the amount of trading.

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[99] *Id.* (quoting *La Jolla Capital Corp.*, Exchange Act Release No. 41755, 54 SEC 275, 1999 WL 624046, at *6 (Aug. 18, 1999)).

[100] *John B. Busacca, III*, Exchange Act Release No. 63312, 2010 WL 5092726, at *10 (Nov. 12, 2010) (quoting *Edwin Kantor*, Exchange Act Release No. 32341, 51 SEC 440, 1993 WL 167840, at *5 (May 20, 1993)), *aff'd*, 449 F. App'x 886 (11th Cir. 2011).

[101] Tr. at 1104.

[102] Ex. JX-202, at 57.

Birkelbach insists that he did not "do nothing" and he points to the fact that he "reviewed trade sheets, order tickets and trade blotters, including Lowry's transactions[,] daily."[103] But despite the fact that this review should have made Birkelbach aware that Murphy was involved in frequent and heavy trading that was inconsistent with Lowry's investor profile, Birkelbach failed to follow up to ensure that Murphy's trading was authorized, suitable, and not excessive.[104] Although Birkelbach contends that he would drop by Murphy's office with some frequency and they would talk about Lowry's account, these conversations did not involve any serious scrutiny by Birkelbach of Murphy's trading. Birkelbach testified that he readily accepted Murphy's explanations about his trading, but at the same time he admitted that he did not even discuss with Murphy the options trading strategy employed in Lowry's account. Even a cursory review of the trading in the account—which Birkelbach insists he was conducting—should have alerted him to numerous potential concerns that he should have raised with Murphy. Despite frequent contact with Murphy, however, Birkelbach failed to take any reasonable steps to limit Murphy's violations.

Birkelbach claims that he believed Lowry was approving every trade because Murphy was frequently talking with Lowry on the phone when Birkelbach would come by his office. But, as FINRA points out, Birkelbach did nothing to verify this assumption, such as speaking with Lowry.[105] Birkelbach argues that he met with Lowry on a few occasions, but the record shows that these face-to-face meetings were either social in nature or simply involved the brief exchange of pleasantries. There is no evidence that Birkelbach used these meetings to obtain any meaningful information from Lowry about whether she understood and approved of Murphy's trading.

Birkelbach also knew from frequent conversations with Langlois, BIS's compliance officer, that Langlois had concerns about Murphy's trading in Lowry's account, including concerns about the volume of trading, losses in the account, and the lack of written discretionary authority. Birkelbach was aware that Langlois sent multiple activity letters to Lowry because of Langlois's concerns over the level of activity in the account. Between September 2002 and April

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[103] Birkelbach's Reply Br. in Supp. of Appl. for Review at 5, 8.

[104] *See Pellegrino*, 2008 WL 5328765, at *10 (finding unreasonable supervision where supervisor was aware that registered representatives were recommending riskier investments than suitable for investors but took no steps to address the problem); *Paul C. Kettler*, Exchange Act Release No. 31354, 51 SEC 30, 1992 WL 320802, at *2 (Oct. 26, 1992) (finding supervisory violations related to an options account where supervisor ignored red flags, such as "heavy trading and severe losses in speculative options trades," and "did not even take the minimal step of questioning [the broker] or [customer] in regard to that activity"); *Tennenbaum*, 1982 WL 31984, at *6 (finding failure to supervise where, despite warnings that employee might be engaging in excessive options trading, supervisor "failed to take or recommend any action to investigate [his] activities" and instead "engaged in 'foot-dragging'").

[105] Birkelbach faults FINRA for suggesting that he should have investigated phone records to verify this assumption, arguing that the phone calls between Murphy and Lowry were "local calls," and suggesting therefore that such calls would not appear on BIS's phone bill. *See* Birkelbach's Reply Br. in Supp. of Appl. for Review at 7. But it would not have taken an extensive investigation for Birkelbach to have a candid conversation with Lowry about whether she was giving approval to Murphy prior to every trade.

2005, Langlois sent eight activity letters to Lowry, each mentioning a "high level of activity" or "active" trading in the account.[106] One activity letter, sent in November 2003, indicated that Lowry had paid year-to-date commissions totaling $251,781. As FINRA notes, this "by itself should have caused a high level of concern."[107] But Birkelbach squandered the opportunity to provide appropriate supervision of Murphy's trading in Lowry's account in relation to the activity letters sent by Langlois. Birkelbach never followed up with Lowry about the letters, and there is no evidence that he followed up with Murphy.

Birkelbach argues that "if highlighting $250,000 in commissions d[id] not raise an eyebrow" from Lowry, he could safely "conclude that Lowry was in accord with the activity in the account."[108] But, as we have noted specifically in the context of customers not complaining following the receipt of activity letters, "'[s]upervisory personnel cannot rely solely upon complaints from customers to bring misconduct of employees to their attention, particularly where customers . . . may fail to realize that they have been mistreated.'"[109] In this case, Lowry was exactly the type of customer who was likely to fail to detect Murphy's violations, because she was an unsophisticated investor, who did not understand her account statements and other documents sent to her by BIS, and who placed significant trust in Murphy. For this reason, Birkelbach's attempt to make Lowry responsible for his own supervisory failures is inappropriate.[110] Moreover, Lowry did, in fact, raise concerns to Murphy about the almost $250,000 in commissions after receiving the letter in question, only to receive false assurances from Murphy that the commissions "didn't matter" because "the account was profitable."[111] If Birkelbach had followed up with Lowry (or Murphy) about the activity letters, he may have discovered that Lowry did have concerns, and he could have taken reasonable steps to address them.[112] In the circumstances, doing nothing more than allowing the activity letters to be sent to

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[106] Ex. RX-40.

[107] *Murphy*, 2011 WL 5056463, at *27.

[108] Birkelbach's Reply Br. in Supp. of Appl. for Review at 6.

[109] *Quest Capital Strategies, Inc.*, Exchange Act Release No. 44935, 55 SEC 362, 2001 WL 1230619, at *6 (Oct. 15, 2001) (quoting *Reynolds & Co.*, Exchange Act Release No. 6273, 39 SEC 902, 1960 WL 56264, at *10 (May 25, 1960)); *see also Albert Vincent O'Neal*, Exchange Act Release No. 34116, 51 SEC 1128, 1994 WL 234316, at *4 (May 26, 1994) (finding deficient supervision when supervisor failed to follow up with customers after sending activity letters).

[110] Similarly, Birkelbach recycles the argument that it was Lowry's desire for $10,000 per month that excuses his conduct in this case because her request would mean that excessive activity in the account was not a red flag. But, for many of the same reasons discussed *supra*, Birkelbach's argument is unavailing. The record does not support the claim that Lowry made a demand for $10,000 monthly. And even if she had, Murphy's trading still should have raised red flags because it was far too risky for a customer like Lowry. Moreover, Applicants have failed to provide an adequate explanation of how Murphy's trading was designed to meet the alleged demand.

[111] Tr. at 148. In addition, when Lowry questioned Murphy earlier about the purpose of the activity letters, he told her they were routine and to simply sign and return them.

[112] Lowry also raised concerns to Murphy about the trading losses in her account and the large margin debt in early 2005, but Murphy again tried to downplay her concerns by telling her that the margin debit balance "wasn't a true indication" of the margin in her account.

Lowry was "wholly inadequate" supervision, particularly when Lowry had been lulled by Murphy's false assurances.[113]

Birkelbach also was aware that Murphy was being investigated by FINRA in relation to the activity in Lowry's account. Murphy testified that by November 2004, FINRA had notified BIS that it was looking into the trading in Lowry's account. By November 2005, FINRA had specifically asked Birkelbach to place Murphy under heightened supervision. Birkelbach also knew of Murphy's relevant disciplinary history, namely, a 1999 disciplinary action brought by the Chicago Board Options Exchange—and sustained by the Commission—finding that Murphy had traded without prior authorization from a customer and had exercised discretion without prior written authorization. In addition to formal disciplinary action, Birkelbach knew that Murphy was the subject of arbitrations and numerous customer complaints, all of which should have prompted Birkelbach to heighten his supervision of Murphy.[114] Indeed, because Murphy had been disciplined for conduct very similar to that at issue in this case, Birkelbach should have been particularly vigilant to investigate the red flags suggesting unauthorized trading. But there is no indication in the record that Birkelbach took steps to supervise Murphy "with the vigilance called for by his disciplinary record."[115]

Birkelbach argues that his supervision was adequate because he "brought in" DeRose to "look over Birkelbach's shoulder" and because Lowry's accountants received duplicate account statements.[116] Birkelbach contends that because none of these individuals said anything to him about the trading in Lowry's account, he was left "to conclude that the activity in Lowry's account was acceptable."[117] But this argument is flawed in several respects. First, the evidence in the record does not support Birkelbach's contention that DeRose was recommended to Lowry as part of "an enhanced supervisory procedure."[118] DeRose, who was not associated with BIS, testified that she was never asked to review Murphy's options trading in Lowry's account; instead, she was hired to make a financial plan for Lowry, and she received Lowry's account statements to help her fulfill that task. Birkelbach's argument is further flawed because the record shows that DeRose did raise concerns to Birkelbach about the "unusually high" level of

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[113] *Quest Capital Strategies, Inc.*, 2001 WL 1230619, at *6 (rejecting the argument that a lack of customer complaints following activity letters was justification for failing to question customers about registered representative, particularly where the representative had "lulled his customers into a false sense of security").

[114] *See Robert J. Prager*, Exchange Act Release No. 51974, 58 SEC 634, 2005 WL 1584983, at *11 (July 6, 2005) (emphasizing that when an individual "has known regulatory problems or customer complaints" there is a "need for heightened supervision"); *Consol. Inv. Servs., Inc.*, Exchange Act Release No. 36687, 52 SEC 582, 1996 WL 20829, at *4 (Jan. 5, 1996) ("Having undertaken to hire and retain such a registered representative [*i.e.*, one with a disciplinary history], Applicants had an obligation to insure that procedures were in place to supervise him properly.").

[115] *Prager*, 2005 WL 1584983, at *11.

[116] Birkelbach's Br. in Supp. of Appl. for Review at 9.

[117] *Id.* at 8.

[118] *Id.* at 7.

activity and commissions in the account, but Birkelbach dismissed these concerns with the assurance that Lowry "is getting really good advice" from Murphy.[119] And Lowry's accountants, who also were not associated with BIS, were never tasked with reviewing the trading in her account. In addition, neither DeRose nor Lowry's accountants had options trading expertise. More fundamentally, Birkelbach—not DeRose or Lowry's accountants—was responsible for supervising Murphy's trading.[120] But instead of accepting and fulfilling his responsibility, Birkelbach abdicated his responsibility and insists that his failures should be excused because of what others might have done.

Birkelbach also failed to provide adequate supervision of Murphy with regard to Martinelli's account. Birkelbach had direct supervisory responsibility over Murphy's trading in Martinelli's account. Although Birkelbach knew that FINRA was investigating Murphy's trading and had requested that Birkelbach heighten his supervision of Murphy, Birkelbach did not change his supervisory approach.[121] His review of the daily tickets and activity report for the account should have alerted Birkelbach to the excessive trading, including several in-and-out trades, but he failed to take any steps to investigate and allowed Murphy to churn Martinelli's account.[122] When Martinelli telephoned Birkelbach in June 2007 to complain about Murphy's trading, Birkelbach failed to verify that Martinelli had given Murphy authority to make trades—even though Birkelbach had admitted to FINRA investigators in May 2006 that he knew that Murphy may have placed trades in Lowry's account without discussing the trades with her beforehand. And even after Martinelli complained, Birkelbach allowed Murphy to continue handling Martinelli's account until the account was closed.

Birkelbach argues that he "discharged his supervisory responsibilities as to Martinelli and treated him in a fair manner" because he "investigated" and "settled with Martinelli."[123] But the evidence in the record does not support Birkelbach's assertion that he made an adequate investigation. As FINRA points out, it was not until the Illinois Securities Department issued a temporary order of prohibition against Murphy on August 31, 2007—over a month after Martinelli closed his account—that Birkelbach heightened in any way his supervision of

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[119] Ex. JX-202, at 115-16.

[120] *Prager*, 2005 WL 1584983, at *11 & n.45 ("We have long maintained that '[f]inal responsibility for supervision of a trading activities at a member firm . . . rests with the firm's president, unless the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties.'" (quoting *Studer*, 2004 WL 2725433, at *6)). There is no evidence that Birkelbach reasonably delegated his supervisory duties related to Lowry's account to anyone—and he could not delegate those duties to individuals not associated with the member firm.

[121] *Id.* at *11 (holding that the failure to heighten supervision in the face of a relevant disciplinary history is a supervisory violation).

[122] *See Tennenbaum*, 1982 WL 31984, at *6 (finding a failure to supervise where supervisor had "specific warnings that [representative] might be engaging in excessive trading" but "failed to take or recommend any action to investigate [his] activities" and "never sought to place any meaningful restraints on [representative]").

[123] Birkelbach's Reply Br. in Supp. of Appl. for Review at 9.

Murphy, and even after the temporary order of prohibition was issued, Birkelbach had still not asked Martinelli if he had authorized Murphy's trading. Moreover, the fact that BIS eventually settled with Martinelli is of no relevance to whether Birkelbach's supervision of Murphy was adequate.

For all of the above reasons, we sustain FINRA's finding that Birkelbach failed to adequately supervise Murphy in violation of NASD Rules 3010, 2860(b)(20), and 2110.

IV.

Applicants argue that FINRA's disciplinary action against them is barred by the statute of limitations in 28 U.S.C. § 2462, which provides that a "proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued." As support for their position, Applicants point to *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996), which held that § 2462 applied to an administrative enforcement proceeding initiated by the Commission. But § 2462 does not apply to FINRA disciplinary proceedings because FINRA is not a government entity.[124] Indeed, we have repeatedly held that "the disciplinary authority of private self-regulatory organizations ('SROs') such as [FINRA] is not subject to any statute of limitation."[125]

Applicants argue that SROs act as the Commission's "surrogates" and therefore *Johnson*'s reasoning should apply to disciplinary proceedings brought by an SRO. This argument misconstrues the Commission's role in SRO disciplinary proceedings. As we have stated:

> SRO proceedings are not initiated by a government agency, nor does their initiation require our approval. We do not participate in the disciplinary proceeding before the SRO, and we do not control when the SRO begins or concludes its determination. Our sole responsibility in this context arises when an SRO imposes a final disciplinary sanction on a person who seeks review of the SRO's determination from this Commission. Moreover, enforcement of the

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[124] *See Faragalli*, 1996 WL 683707, at *10 n.36 (holding that "*Johnson* is inapplicable to SRO proceedings" because "SROs are private organizations"); *see also Larry Ira Klein*, Exchange Act Release No. 37835, 52 SEC 1030, 1996 WL 597776, at *6 (Oct. 17, 1996) ("We do not believe that [§2462] applies to disciplinary proceedings brought by a self-regulatory organization ('SRO')."); *United States v. Inc. Village of Island Park*, 791 F. Supp. 354, 367 (E.D.N.Y. 1992) ("Section 2462 applies *only* to actions brought by the United States." (emphasis in original)); *Erie Basin Metal Prods., Inc. v. United States*, 150 F. Supp. 561, 566 (Ct. Cl. 1957) ("The limitation of section 2462 applies only to actions instituted by the Government.").

[125] *Gluckman*, 1999 WL 507864, at *6; *see also William D. Hirsh*, Exchange Act Release No. 43691, 54 SEC 1068, 2000 WL 1800614, at *5 (Dec. 8, 2000) ("We have consistently held that no statute of limitations applies to the disciplinary actions of the Exchange or other self-regulatory organizations ('SROs')."); *Faragalli*, 1996 WL 683707, at *10 ("[I]t is well established that no statute of limitations applies to the disciplinary actions of the Exchange or other self-regulatory organizations ('SROs').").

> sanctions imposed will be the direct responsibility of the SRO, and any fine will be payable to the SRO, not the United States Treasury.[126]

Furthermore, courts and the Commission have held that SROs are generally not subject to the requirements and duties applicable to government agencies.[127]

Moreover, even if § 2462 were to apply, it would not bar FINRA's action here because the vast majority of the violative conduct in this case occurred within five years of FINRA's filing its complaint, and all of the violations culminated within that period.[128] Indeed, conduct by Applicants sufficient to sustain each of the violations under review continued until well after July 30, 2003—the date five years before FINRA issued its complaint. For all of the above reasons, we conclude that § 2462 does not bar FINRA's disciplinary proceeding against Applicants.

V.

Section 19(e) of the Exchange Act directs us to sustain FINRA's sanctions unless we find, having due regard for the public interest and the protections of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[129] Although we are not bound by FINRA's Sanction Guidelines, "we use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2)."[130]

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[126] *Klein*, 1996 WL 597776, at *6.

[127] *See, e.g.*, *Shultz v. SEC*, 614 F.2d 561, 569 (7th Cir. 1980) (holding that the Administrative Procedure Act did not apply to a disciplinary proceeding of the Chicago Board Options Exchange, Inc., because "[t]he Exchange is a Delaware non-stock corporation and not an authority of the Government"); *United States v. Solomon*, 509 F.2d 863, 868-69 (2d Cir. 1975) (holding that privilege against self-incrimination does not apply in investigation by the New York Stock Exchange and rejecting the argument that "interrogation by NYSE must be deemed the equivalent of interrogation by the United States because the Exchange has become in effect the arm of the Government in administering portions of the Securities Exchange Act") (Friendly, J.); *Daniel Turov*, Exchange Act Release No. 31649, 51 SEC 235, 1992 WL 394575, at *3 (Dec. 23, 1992) (NYSE disciplinary action not subject to challenge under various constitutional provisions because "the Exchange is not the government"). *But cf. D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104 (2d Cir. 2001) (holding that NYSE is immune from liability for claims arising out of the discharge of its duties under the Exchange Act).

[128] *Faragalli*, 1996 WL 683707, at *10 n.36 ("In any event, much of the conduct at issue in this case occurred within five years of the institution of proceedings, and all of the violations culminated within that period. Thus, these proceedings would not be barred by Section 2462 even if that section were deemed to apply."); *cf. Nat'l Parks Conservation Ass'n, Inc. v. Tenn. Valley Auth.*, 480 F.3d 410, 416 (6th Cir. 2007) (holding that an action is timely under § 2462 so long as it identifies "a wrongful act that took place within five years" of filing suit).

[129] 15 U.S.C. § 78s(e)(2). Applicants do not claim, nor does the record show, that FINRA's actions imposed an unnecessary or inappropriate burden on competition.

[130] *PAZ Sec., Inc.*, Exchange Act Release No. 57556, 2008 WL 1697153, at *3 (Apr. 11, 2008).

A. The remedial sanctions FINRA imposed on Murphy are not excessive or oppressive.

For all of his violations, except misleading communications, FINRA barred Murphy in all capacities and ordered him to pay $585,174.67 in disgorgement.[131] FINRA's Sanction Guidelines recommend up to a bar for egregious cases of churning, excessive trading, unsuitable recommendations, and unauthorized trading.[132] We agree with FINRA that there are several aggravating factors that support its finding that Murphy's violations were egregious and warrant a bar.

Murphy is a recidivist with a history of discipline related to his sales practices. Murphy's prior Commission-sustained discipline by the Chicago Board Options Exchange—for unauthorized trading and discretionary trading without proper authorization—involved conduct similar to the conduct at issue here, supporting the conclusion that the investing public should be protected from the potential of similar violations in the future.[133] In addition, Murphy's misconduct in this case involved multiple violations occurring over a period of several years.[134] Murphy's misconduct also benefitted himself while injuring his customers.[135] He earned over a

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[131] FINRA considered all of the violations except misleading communications as part of the same course of conduct, and in light of the bar imposed for these violations, did not impose a separate sanction for Murphy's use of misleading communications.

[132] *See* FINRA Sanction Guidelines at 82, 99, 103. For exercising discretion without written authorization, the Guidelines recommend in egregious cases a suspension from 10 to 30 business days. *Id.* at 90.

[133] *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at *16 (Jan. 20, 2012) ("'We have long recognized that prior disciplinary history . . . provides evidence of whether an applicant's misconduct is isolated, the sincerity of the applicant's assurance that he will not commit future violations and/or the egregiousness of the applicant's misconduct.'" (quoting *Consol. Inv. Servs.*, 1996 WL 20829, at *6)); Sanction Guidelines at 2 ("Disciplinary sanctions should be more severe for recidivists"—particularly in cases where "past misconduct [is] similar to that at issue" or "evidences a disregard for regulatory requirements, investor protection, or commercial integrity.").

[134] *See* Sanction Guidelines at 6 (providing that "[w]hether the respondent engaged in numerous acts and/or a pattern of misconduct" and "[w]hether the respondent engaged in the misconduct over an extended period of time" are principal considerations in determining sanctions). In connection with his argument that FINRA's "sanctions are not appropriate given the surrounding circumstances," Murphy noted before the NAC in 2010 that his alleged misconduct related to Lowry "began almost 7 years ago, and for Martinelli, 3 years have passed." NAC Appeal Br. of Appellants-Resp'ts at 22. But this ignores the fact that Murphy's mishandling of Lowry's account continued for over three years until she decided to close her account in early 2006. And in any event, we do not believe the amount of time that has passed since Murphy's violative conduct is mitigating under the circumstances. *Cf. James Gerard O'Callaghan*, Exchange Act Release No. 61134, 2009 WL 4731651, at *5 (Dec. 10, 2009) (rejecting the argument "that the 'mere passage of time' . . . without engaging in similar conduct is mitigating" in determining whether a suspension was excessive or oppressive); *Gregory O. Trautman*, Exchange Act Release No. 61167A, 2009 WL 6761741, at *21 (Dec. 15, 2009) (finding that conduct over six years before the issuance of the Commission's opinion was "relatively recent" and supportive of a cease-and-desist order).

[135] *See id.* (providing that "whether the respondent's misconduct resulted directly or indirectly in injury" is a principal consideration in determining sanctions).

half million dollars in commissions churning Lowry's and Martinelli's accounts, while Lowry lost $871,301.95 and Martinelli lost $5,703.59 from his trading.[136]

We also agree with FINRA that Murphy acted with intent.[137] Murphy's excessive trading evidenced scienter because Murphy placed his own interest in earning commissions above the interest of his customers. And given his disciplinary history, Murphy knew or was reckless in not knowing that he could not exercise discretionary authority in either Lowry's or Martinelli's accounts without their written consent.[138] Similarly, Murphy must have known that his risky options trading in Lowry's account was neither authorized by Lowry nor appropriate for an unsophisticated investor with a moderate tolerance for risk.

Murphy also attempted to conceal his misconduct from Lowry and from BIS.[139] Murphy gave false assurances to Lowry about the profitability of her account, never disclosed to her the risks involved in the options trading he was pursuing or that he was deviating from a covered call strategy, told her the activity letters sent to her by Langlois were only a formality, and sent her misleading profit-and-loss statements that frequently overstated the profits in her account. And Murphy misled Langlois, BIS's compliance officer, by telling him that Lowry had authorized every trade. In addition, Murphy attempts to minimize his wrongdoing and shift blame to others, such as Lowry, Pesavento, and DeRose.[140] In light of these significant aggravating factors, we

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[136] The net loss to Lowry of approximately $93,821 from Murphy's management of her account was considerably less than the options trading losses, primarily given the appreciation in the value of her P&G stock—a fact that FINRA took into account when fashioning its sanctions. But, as FINRA points out, the options trading losses are also highly relevant to the sanctions analysis, because Lowry's account would be worth much more had Murphy not engaged in excessive and unsuitable options trading. *See Bucchieri*, 1996 WL 254677, at *5 (noting that, even for customers who had not suffered a net loss, "the effect that [broker's] trading had in reducing . . . customers' profits" was relevant in the sanctions analysis). Indeed, as suggested previously, without the significant appreciation of Lowry's P&G stock (something for which Murphy can take no credit) the net loss to Lowry would have been substantially greater.

[137] *See* Sanction Guidelines at 7 (providing that "[w]hether the respondent's misconduct was the result of an intentional act" is a principal consideration in determining sanctions).

[138] Although Lowry gave Murphy oral permission to conduct trades without her prior authorization and Murphy contends that he understood Martinelli to give him oral permission to pursue the strategy they discussed, we agree with FINRA that, under the circumstances, this is not mitigating evidence. *See* Sanction Guidelines at 90 (providing that "[w]hether customer's grant of discretion was express or implied" is a principal consideration in determining sanctions for violations of the rule against discretionary trading without authorization). First, Murphy exceeded the permission granted to him by Lowry by pursuing risky options trades not part of the covered call strategy she had requested. Second, Martinelli provided credible testimony that he did not give Murphy permission to trade.

[139] *See* Sanction Guidelines at 6 (providing that "[w]hether the respondent attempted to conceal his or her misconduct or to lull inactivity, mislead, deceive or intimidate a customer . . . or . . . the member firm with which he or she is/was associated" is a principal consideration in determining sanctions).

[140] *See id.* (providing that "[w]hether an individual . . . accepted responsibility for and acknowledged the misconduct" is a principal consideration in determining sanctions).

believe that a bar is neither excessive nor oppressive and is appropriate to protect investors from further misconduct by Murphy.[141]

The disgorgement order also serves the remedial purpose of depriving Murphy of the benefit of his misconduct.[142] The Sanction Guidelines provide that payment of disgorgement should be required in all sales practice cases in which "the respondent has retained substantial ill-gotten gains."[143] FINRA found that Murphy's churning of Lowry's and Martinelli's accounts resulted in commissions to him personally of $591,933.67.[144] In reaching a disgorgement amount, FINRA deducted $5,000 for the fine Murphy paid to the Illinois Securities Department and $1,759 for commission reimbursements that Martinelli acknowledged receiving. The resulting $585,174.67 is a reasonable approximation of the ill-gotten gains Murphy retained from his violative conduct, and we thus sustain FINRA's disgorgement order.[145]

Murphy's arguments against the sanctions imposed by FINRA are unpersuasive. Murphy argues that the settlements reached with Lowry and Martinelli support a lesser sanction. Although the Sanction Guidelines recognize that a voluntary and reasonable attempt, "prior to detection and intervention, to pay restitution or otherwise remedy the misconduct" may be mitigating,[146] the settlements reached with both Lowry and Martinelli came about only after the customers lodged formal complaints and FINRA had begun its investigation.[147] And Murphy's

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[141] *See, e.g.*, *Clyde J. Bruff*, 1998 WL 730586, at *4-5(1998) (finding that bar was neither excessive or oppressive in churning case in which representative had a relevant disciplinary history, attempted to shift blame to customer, and customer was an unsophisticated investor).

[142] *See Michael David Sweeney*, Exchange Act Release No. 29884, 50 SEC 761, 1991 WL 716756, at *5 (Oct. 30, 1991) ("[D]isgorgement is intended to force wrongdoers to give up the amount by which they were unjustly enriched.").

[143] Sanction Guidelines at 10.

[144] From July 2002 through December 2003, Murphy earned 60% of gross commissions in Lowry's account, and from January 2004 through February 2006 he earned 58%. This resulted in $588,804.12 in personal commissions from trading in Lowry's account. FINRA assumed that his payout remained at 58% during the time he managed Martinelli's account, which means he personally earned $3,129.55 from trading in Martinelli's account. These calculations were not challenged before FINRA and are not challenged before the Commission.

[145] *See Roche*, 1997 WL 328870, at *6 (finding that total commissions represented a reasonable approximation of ill-gotten gains retained from churning); *Canady*, 1999 WL 183600, at *10 n.35 (noting that "courts have held that '[t]he amount of disgorgement ordered need only be a reasonable approximation of profits causally connected to the violation [and that] any risk of uncertainty [in calculating disgorgement] should fall on the wrongdoer whose illegal conduct created that uncertainty'" (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1475 (2d Cir. 1996) (alterations in original and internal quotation marks omitted)); *Sweeney*, 1991 WL 716756, at *5 (sustaining the disgorgement of all commissions in a case of excessive trading and noting that "courts have approved action like that taken by the NASD here in civil actions involving excessive trading, basing their determinations on the difficulty of specifying a 'correct' level of trading and the conclusion that the burden of this problem should be borne by the broker who caused it" (citing *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1374 (7th Cir. 1983) and *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975))).

[146] Sanction Guidelines at 6.

[147] *See Cody*, 2011 WL 2098202, at *21 (rejecting argument that settlements with customers were mitigating

(continued...)

offer during a telephone call with Martinelli to refund some commissions was not a reasonable attempt to remedy the misconduct, because Murphy continued to mislead Martinelli regarding the trading activity and the true amount of losses in his account. Moreover, we agree with FINRA that Murphy failed to demonstrate that the customers' settlements with BIS provide a basis to decrease the disgorgement amount. Although Murphy's counsel, at the hearing before the NAC, made a vague assertion that Murphy was responsible for the "lion's share" of the settlement with Lowry, Murphy failed to show his contribution to the settlements.[148] Under the circumstances, we agree with FINRA that Murphy has not met his burden of demonstrating why and by how much the disgorgement amount should be reduced as a result of the settlements with Lowry and Martinelli.

Murphy also attacks the fairness of FINRA's sanctions given that he was disciplined by the Illinois Securities Department for conduct related to his handling of Martinelli's account. Following a complaint by Martinelli, the Illinois Securities Department pursued a disciplinary action that resulted in Murphy's agreeing to an order finding that he traded Martinelli's securities without written authorization and for the purpose of generating commissions in violation of Section 8.E(1)(b) of the Illinois Securities Law of 1953. The consent order fined Murphy $5,000, required the reimbursement of some commissions to Martinelli, and prohibited Murphy from acting as a supervisor or taking on new clients for two months. Beyond the NAC's decision to reduce the disgorgement ordered by the amount of the fine paid by Murphy to the Illinois Securities Department, we agree with FINRA that there is no basis to reduce its sanctions because Murphy entered into a consent order with state regulators regarding some of the same conduct at issue here. There is nothing unfair about FINRA's pursuing a disciplinary action for violations of its own rules and the Exchange Act while a state regulator pursues parallel disciplinary action under state law for some of the same conduct.[149] We agree with FINRA that the fact that Murphy was disciplined in Illinois for a portion of the misconduct at issue in this proceeding does not mean that Murphy is any less a threat to the investing public or that he has retained any less in ill-gotten gains than FINRA ultimately ordered disgorged.[150]

(...continued)
when the settlements were entered into after customers complained and the registered representative's firm had investigated).

[148] As part of his Statement of Financial Condition submitted to FINRA in support of his claim of inability to pay the disgorgement amount, Murphy included a promissory note to BIS for $100,000. Because there is no evidence in the record linking the promissory note to the Lowry settlement, however, we cannot determine its relevance.

[149] *Cf. Kirk A. Knapp*, Exchange Act Release No. 31556, 51 SEC 115, 1992 WL 365568, at *11 (Dec. 3, 1992) (rejecting the argument that NASD was precluded from pursuing an action against a respondent for conduct that was already the subject of an SEC administrative action and noting that "NASD has an independent statutory mandate to enforce the provisions of the Exchange Act, as well as its own rules").

[150] Murphy also argues that his sanctions are "not warranted by the evidence" because "the Martinelli account had a life-span of three months with Murphy" and "Lowry directed Mr. Murphy to generate premium income for her of $10,000 per month." NAC Appeal Br. of Appellants-Resp'ts at 23. We have already considered and rejected these arguments in the context of Murphy's violations, *see supra* notes 82-84 and accompanying text; *supra* at 19-20, and for the same reasons, we believe that they do not serve to mitigate Murphy's misconduct in the context of our review of the sanctions imposed by FINRA.

Before the NAC, Murphy argued for the first time that he was unable to pay the monetary sanctions. Murphy submitted evidence to support his claim, but the NAC ultimately concluded that the materials Murphy submitted were unreliable and found that Murphy failed to demonstrate an inability to pay the disgorgement order. Although we have recognized that "a *bona fide* inability to pay a judgment is an important consideration in determining whether [a] sanction . . . is excessive or oppressive,"[151] "[i]t is well settled that a respondent bears the burden of demonstrating an inability to pay, and that [FINRA] is entitled to make a searching inquiry into any such claim."[152]

We agree with FINRA that Murphy has failed to meet that burden here. Murphy failed to submit some financial information requested by FINRA, and the information he did submit was often incomplete, inconsistent, and unreliable. For example, FINRA's Statement of Financial Condition required Murphy to submit federal and state tax returns filed during the prior two years, but Murphy submitted only his 2009 income tax returns. The statement also required Murphy to submit pay stubs for the previous eight pay periods, but he provided only a spreadsheet of unknown origin purporting to list payments to him in 2010. Murphy claimed in the Statement of Financial Condition that he has no bank account, but as FINRA points out, this seems questionable given that he received substantial monthly income and that he apparently pays at least one of his credit cards from a "funding account." Likewise, Murphy's claim that he owns only one car (a 1982 Toyota he values at $5,700) appears inconsistent with his claim that he owes $10,049 on an auto loan and with the $2,007 deduction he took for "new motor vehicle taxes" on his 2009 federal tax return. As FINRA also points out, Murphy's claim of $59,723 in monthly expenses is unreliable as the figure appears to include some monthly and some yearly expenditures. In sum, given the gaps, inconsistencies, and seeming inaccuracies in Murphy's financial submission, we agree that the information Murphy submitted is unreliable and sustain FINRA's finding that Murphy failed to demonstrate an inability to pay the disgorgement order.

B. The remedial sanction FINRA imposed on Birkelbach is not excessive or oppressive.

FINRA barred Birkelbach for his supervisory failures. Birkelbach contends that a bar in all capacities is not appropriate for the supervisory violations at issue here. Pointing to the sanctions imposed in other disciplinary cases, Birkelbach argues that a bar is an unprecedented and unwarranted sanction in the circumstances. He also suggests that the NAC's increase of the sanction was unfair and designed to punish him for appealing the hearing panel's decision. For the reasons that follow, we reject these arguments and conclude that Birkelbach has failed to show that FINRA's sanction is excessive or oppressive.

Birkelbach argues that "when the offense involves actions performed in a supervisory capacity, it is proper for any suspension or bar to be limited to the supervisory capacity."[153] But

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[151] *Bruce M. Zipper*, Exchange Act Release No. 33376, 51 SEC 928, 1993 WL 538925, at *2 (Dec. 23, 1993).

[152] *Castle Sec. Corp.*, Exchange Act Release No. 52580, 58 SEC 826, 2005 WL 2508169, at * 6 (Oct. 11, 2005).

[153] Birkelbach's Reply Br. in Supp. of Appl. for Review at 10.

the Sanction Guidelines recommend up to a bar "in any or all capacities" for egregious supervisory failures.[154] This recommendation is based on solid reasoning: in some circumstances supervisory failures are so serious that a bar in all capacities is an appropriate sanction to protect investors from individuals who have shown themselves unfit to remain in the industry. Contrary to Birkelbach's claim, suspensions or bars in all capacities for supervisory violations are not unprecedented—we recently rejected the argument that a suspension in all capacities was "not sufficiently tailored to" misconduct that "involved only supervisory violations."[155] Because proper supervision serves such an important role in protecting investors, egregious violations of supervisory rules often warrant the most severe sanctions.[156]

Such is the case here. Despite numerous and obvious warning signs, including an awareness of Murphy's disciplinary history involving unauthorized trading, Birkelbach permitted Murphy's churning of Lowry's account to continue for years without taking any reasonable steps to curb Murphy's unauthorized, unsuitable, and excessive trading. And even after he was aware that FINRA was investigating Murphy and had recommended increased supervision, Birkelbach assigned Martinelli's account to Murphy and did nothing while Murphy aggressively churned that account. As a result, Murphy's customers incurred significant harm. Given Birkelbach's complete failure to take reasonable supervisory steps in the face of obvious red flags, we agree with FINRA that Birkelbach's supervisory failures appear to involve some degree of intent. Indeed, Birkelbach had an economic incentive to permit Murphy's churning. Lowry's account represented 18% of BIS's total revenue from the third quarter of 2002 through the end of 2005, and Birkelbach had a financial stake in BIS.

In addition, Birkelbach has a relevant disciplinary history. In 1999, the Illinois Securities Department censured Birkelbach, imposed a six-month suspension with a requalification requirement, and ordered $50,000 in restitution to five customers for unauthorized trading, unsuitable transactions, excessive trading, and churning customer accounts—the same conduct that Birkelbach's supervisory failures allowed to occur here. Given his own misconduct in these areas, Birkelbach should have been particularly careful about detecting and preventing similar

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[154] Sanction Guidelines at 108.

[155] *Dennis S. Kaminski*, Exchange Act Release No. 65347, 2011 WL 4336702, at * 14 (Sept. 16, 2011) (sustaining 18-month suspension in all capacities for supervisory failures); *see also Michael Studer*, 2004 WL 2735433, at *7 (sustaining bar for failure to supervise); *Dep't of Mkt. Reg. v. Kresge*, Complaint No. CMS030182, 2008 WL 4592834, at *3-10 (NAC Oct. 9, 2008) (barring respondent for failure to supervise, to register an individual, and to report customer complaints). Birkelbach's argument that the NAC's sanction "appears unprecedented" has shifted. Birkelbach's Reply Br. in Supp. of Appl. for Review at 10. In his opening brief, he argued none of the cases cited in the NAC decision involved a bar in all capacities for supervisory violations. Then, in his reply brief, after FINRA had come forward with relevant cases, he argued that the NAC's *increasing* a sanction from a suspension to a bar is unprecedented. In any event, the sanction imposed here is consistent with the Sanction Guidelines, and, as discussed *infra*, we evaluate the sanction in the context of the particular facts and circumstances of the case before us, not in relation to other cases.

[156] *See Kaminski*, 2011 WL 4336702, at * 11 ("Proper supervision is the touchstone to ensuring that broker-dealer operations comply with the securities law and NASD rules. It is also a critical component ensuring investor protection.").

misconduct by those whom he supervised. And Birkelbach's prior discipline for misconduct related to his own customers supports FINRA's conclusion that a bar in all capacities is appropriate for the protection of investors because of the supervisory failures in this matter. More recently, Birkelbach consented to a FINRA order censuring him and imposing a 30-day suspension in all capacities, a 90-day suspension in principal capacities, and a $25,000 fine for alleged conduct between 2007 and 2009 that included, *inter alia*, a failure to adequately supervise in violation of NASD Rules 3010 and 2010.[157] Another aggravating factor is Birkelbach's continued insistence on shifting the blame for his supervisory failures to others, such as Lowry, DeRose, and Lowry's accountants. Under the circumstances, we agree with FINRA that Birkelbach's supervisory failures are egregious and that a bar in all capacities is an appropriate sanction, one necessary to protect the investing public from further harm.

Birkelbach points to other disciplinary cases in arguing that FINRA's sanction is unwarranted, but Birkelbach's reliance on other cases is misplaced for several reasons. First, as we consistently have held, the appropriateness of a sanction "depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with action take in other proceedings."[158] In any event, the FINRA cases relied upon by Birkelbach—*Department of Enforcement v. Pellegrino*[159] and *Department of Enforcement v. Midas Securities, LLC*[160]—are readily distinguishable. In *Pellegrino*, the NAC modified a hearing panel's sanction for a supervisor from a suspension in all capacities to a bar in any principal capacity. But Pellegrino's misconduct was less severe than Birkelbach's: it involved supervisory failures over less than two years, the underlying violations involved only unsuitable recommendations, Pellegrino made mitigating compliance efforts, and he had no relevant disciplinary history.[161] In *Midas*, the NAC suspended three principals in a principal capacity for 30 business days, 45 business days, and two years for failing to establish and maintain a reasonable supervisory system and failing to supervise registered representatives who were selling unregistered securities. The underlying facts in *Midas* are different than those in the present case: the violations occurred over just four months, there was no evidence of customer harm, and two of

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[157] On November 14, 2011, FINRA filed a motion to adduce additional evidence related to this subsequent disciplinary history. We grant FINRA's motion.

[158] *PAZ Sec., Inc.*, 2008 WL 1697153, at *9; *see also Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973) ("'The employment of a sanction within the authority of an administrative agency is thus not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases."); *Hiller v. SEC*, 429 F.2d 856, 858 (2d Cir. 1970) ("[W]e cannot disturb the sanctions ordered in one case because they were different from those imposed in an entirely different proceeding."); *David Wong*, Exchange Act Release No. 45426, 55 SEC 602, 2002 WL 200089, at *5 (Feb. 8, 2002) ("We consistently have held that the appropriate sanctions in a case depend on its particular facts and circumstances and cannot be determined by comparison with action taken in other cases.").

[159] Complaint No. C3B20050012, 2008 WL 115195 (NAC Jan. 4, 2008), *aff'd*, 2008 WL 5328765.

[160] Complaint No. 2005000075703, 2011 WL 786035 (NAC Mar. 3, 2011), *aff'd*, 2012 WL 169138, *and aff'd sub nom. World Trade Financial Corp.*, Exchange Act Release No. 66114, 2012 WL 32121 (Jan. 6, 2012).

[161] *See Pellegrino*, 2008 WL 5328765, at *4-6, *17.

the principals had no disciplinary history.[162] *Pellegrino* and *Midas* provide no basis for us to question FINRA's choice of sanction here.

Finally, Birkelbach insists that it was inappropriate for the NAC to increase the hearing panel's sanction, and he suggests that the NAC was motivated by bias or a desire to retaliate against him for bringing an appeal. It is well established, however, that "the NAC reviews hearing panel decisions *de novo* and has broad discretion to review hearing panel decisions and sanctions."[163] FINRA's rules make clear that the NAC "may affirm, modify, reverse, increase, or reduce any sanction, or impose any other fitting sanction."[164] Moreover, "FINRA is not required to state why a lesser sanction would be insufficient in order to justify the sanction it imposed as being remedial."[165] Furthermore, we find nothing in the record to support Birkelbach's vague claim of improper bias on the part of FINRA or that the sanction increase was in retaliation for Birkelbach's bringing the appeal.[166]

In sum, considering the evidence in the record, we agree with FINRA's assessment "that Birkelbach is a serious risk to the investing public, in whatever capacity he would function, that his failure to supervise was egregious, and that sanctions at the high end of the relevant range are warranted."[167] Accordingly, we conclude that barring Birkelbach in all capacities is neither excessive nor oppressive and that the sanction serves a remedial purpose of protecting investors and deterring future misconduct.

An appropriate order will issue.[168]

By the Commission (Chair WHITE and Commissioners WALTER, PAREDES and GALLAGHER); Commissioner AGUILAR not participating.

Elizabeth M. Murphy
Secretary

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[162] *See Midas Sec., LLC*, 2011 WL 786035, at *3, *8-11.

[163] *Cody*, 2011 WL 2098202, at *21.

[164] NASD Rule 9348; *see also Cody*, 2011 WL 2098202, at *21; *Harry Friedman*, Exchange Act Release No. 64486, 2011 WL 1825025, at *7 (May 13, 2011). Birkelbach acknowledged in a brief before the NAC that under FINRA rules the NAC could increase the sanctions imposed by the hearing panel, so his suggestion that he was somehow blindsided by the increase rings hollow.

[165] *Friedman*, 2011 WL 1825025, at *7.

[166] The NAC's decision—consistent with the Sanction Guidelines—took into account Birkelbach's failure to accept responsibility for his actions, finding that this was evidenced not by his decision to appeal but by his continued attempts to shift blame to others.

[167] *Murphy*, 2011 WL5056463, at *37.

[168] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 69923 / July 2, 2013

Admin. Proc. File No. 3-14609

In the Matter of the Application of

WILLIAM J. MURPHY and CARL M. BIRKELBACH

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken, and the costs imposed, by FINRA against William J. Murphy and Carl M. Birkelbach are sustained.

By the Commission.

Elizabeth M. Murphy
Secretary