

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

[REDACTED]

ERIK MATZ
(CRD No. 2715303),

[REDACTED]

and

[REDACTED]

Respondents.

**Disciplinary Proceeding
No. CLI050014**

Hearing Officer -

Upon information and belief, the Department of Enforcement alleges that:

JURISDICTION

1. Respondent [REDACTED] a broker-dealer, has been a member of NASD since on or about April 25, 1997.
2. Respondent Erik Matz ("Matz") first became registered with NASD, as a General Securities Representative ("GSR"), on approximately April 27, 1996. Matz is currently registered with NASD through member firm, [REDACTED] Matz has been employed with [REDACTED] since on or about October 4, 2002.
3. Respondent [REDACTED] first became registered with NASD, as a GSR on approximately December 22, 1993. He also became registered as a General Securities Principal ("GSP") on approximately September 18, 1997. [REDACTED] is currently registered with NASD through member firm, [REDACTED] has been

employed with [REDACTED] since on or about October 4, 2002. Among the member firms that [REDACTED] previously has been registered with, between approximately August 29, 1994 and August 25, 1995, [REDACTED] was registered with Stratton Oakmont, Inc. (BD No. 18692)(“Stratton”). Stratton was expelled by the Securities and Exchange Commission in 1996 and its representatives are subject to the “taping rule” under NASD Conduct Rule 3010.

4. Respondent [REDACTED] first became registered as a GSR on or about November 4, 1994 and as a GSP on or about March 1, 1996. [REDACTED] is also registered as a Financial and Operations Principal, Equity Trader, Municipal Securities Principal and Registered Options Principal with NASD through [REDACTED]. [REDACTED] is the president of [REDACTED] and has an ownership stake of more than 75% in the firm. [REDACTED] is currently registered with NASD through member firm, [REDACTED]

FIRST CAUSE OF COMPLAINT
(Excessive Trading; Churning – Matz)
(Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5
thereunder; NASD Conduct Rules 2110, 2120 and 2310(a))

5. Paragraphs 1 through 4 are re-alleged and incorporated herein by reference.

Customer EH

6. In or about October 2002, Matz became the registered representative for customer EH’s account at [REDACTED]. At that time, EH’s account at [REDACTED] was worth approximately \$1,234,257.00.
7. EH’s new account form, completed when she opened her account with [REDACTED] in April 2002, indicated that EH was a 62-year old schoolteacher with an annual income of approximately \$47,000.00. According to her new account form, EH had a net worth of approximately \$1,200,000.00. On her new account form, EH indicated that her

investment objectives were “capital appreciation.” By the time that Matz took over the trading in EH’s account, EH had retired and was no longer earning an income of \$47,000.00. After taking over her account, at no point did Matz procure a new or updated account form for EH.

8. Matz recommended the trades in EH’s account. EH relied upon and followed Matz’s recommendations for the trades in her [REDACTED] account.
9. In October 2002 alone, Matz executed approximately 110 transactions in EH’s account. In November 2002, Matz executed an additional 28 transactions in EH’s account. During that approximately two-month period, the 138 transactions were executed in the account at a total cost of \$246,238.07.
10. From approximately October 9, 2002 through December 19, 2002, the trading in EH’s account generated approximately \$243,616.23 in commissions.
11. As a result of Matz’s trading in her account, EH suffered losses of approximately \$708,724.52, including commissions.
12. For the period of approximately October 9, 2002 through December 19, 2002, the cost-to-equity ratio, which is calculated by dividing the total of all transaction costs incurred in an account by the average equity in the account, was 104% annualized.

Customer MW

13. In or about October 2002, Matz became the registered representative for customer MW’s account at [REDACTED]. At that time, MW’s account at [REDACTED] was worth approximately \$142,000.00.
14. MW’s new account form, completed when she opened her account with [REDACTED] in April 2002, indicated that MW was a 62-year old hairdresser who owned a beauty salon.

According to her new account form, MW had an annual income of approximately \$25,000.00 and a net worth of approximately \$100,000.00 to \$250,000.00. On her new account form, MW indicated that her investment objectives were “capital appreciation.” After taking over her account, at no point did Matz procure a new or updated account form for MW.

15. Matz recommended the trades in the account. MW relied upon and followed Matz’s recommendations for the trades in her [REDACTED] account.
16. For the period on or about October 15, 2002 through on or about November 14, 2002, Matz executed approximately 34 transactions in the account at a total cost of \$33,531.51.
17. From on or about October 15, 2002 through on or about November 14, 2002, the trading in MW’s account generated approximately \$33,426.71 in commissions.
18. As a result of Matz’s trading in her account, MW suffered losses of approximately \$90,652.22, including commissions.
19. For the period of on or about October 15, 2002 through on or about November 14, 2002, the cost-to-equity ratio was annualized at 153%. The turnover rate in an account measures the number of times during a given period that the securities in the account are replaced by new securities, and is calculated by dividing the total cost of purchases by the average equity in the account. The total turnover ratio for that period was 3.95, or 23.71 annually. This means that the account was turned over approximately four times in that one-month period.
20. By virtue of this conduct, Matz, by the use of any means or instrumentality of interstate commerce or of the mails, intentionally or recklessly engaged in

manipulative or deceptive devices or contrivances in connection with the purchase or sale of securities, and intentionally or recklessly effected transactions in, or induced the purchase or sale of, securities by means of manipulative, deceptive or other fraudulent devices or contrivances.

By reason of the foregoing, Matz violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, NASD Conduct Rules 2110, 2120 and 2310(a).

SECOND CAUSE OF COMPLAINT
(Failure to Supervise - [REDACTED])
(Violations of NASD Conduct Rules 3010 and 2110)

21. Paragraphs 1 through 20 are re-alleged and incorporated herein by reference.
22. From on or about October 9, 2002 through on or about December 19, 2002, [REDACTED] was Matz's supervisor. He was the sole principal at the branch office and his duties were to supervise Matz and one other registered representative at that branch.
23. In October 2002, at the time when both Matz and [REDACTED] first became employed with [REDACTED] Matz had two disciplinary actions on his Uniform Application for Securities Industry Registration or Transfer ("Form U-4"). One involved an order, from on or around January 21, 1999, in which the State of Iowa ordered Matz to cease-and-desist engaging in dishonest or unethical practices related to the sale of an initial public offering. The order alleged that Matz engaged in excessive and unauthorized trading as well as material misrepresentations and omissions of material fact. The second action related to a Letter of Acceptance, Waiver and Consent that Matz entered into with NASD, on or about April 20, 2001, for exercising discretionary authority in a customer's account without prior written authorization and acceptance.

24. At the time he was hired by [REDACTED] Matz had four customer complaints and/or arbitrations listed in the Central Registration Depository ("CRD"). These matters occurred between 1997 and 1999 and included, but were not limited to, allegations of excessive trading, misrepresentations and excessive commissions.
25. From in or around October 2002 through on or about December 2002, [REDACTED] knew, or should have known, that Matz was churning the accounts of EH and MW. [REDACTED] job duties and responsibilities as supervisor included listening to conversations between the representatives and customers, reviewing accounts and reporting complaints. [REDACTED] knew, or should have known, of numerous "red flags" indicating the churning. [REDACTED] reviewed the commission blotter on a daily basis. The blotter would have indicated the excessive level of trading and commissions generated by Matz in EH's and MW's accounts. Prior to every trade Matz placed, Matz would orally advise [REDACTED] would orally approve the trade. In addition, [REDACTED] reviewed accounts on a monthly basis and part of that review was for trading activity. Such a review should have identified the excessive trading that was occurring in EH's and MW's accounts. Further, as noted above in paragraphs 23-24, Matz had a prior disciplinary history involving sales practice misconduct, and a history of complaints alleging sales practice misconduct, that warranted closer scrutiny by [REDACTED] of Matz's trading activities.
26. From on or about October 4, 2002 through on or about December 19, 2002, the trading in EH's and MW's accounts generated commissions of approximately \$277,042.94. [REDACTED] Matz's supervisor, benefited financially from the excessive trading in EH's and MW's accounts. Specifically, the commission structure at [REDACTED]

was set up so that Matz and [REDACTED] each received 25% and [REDACTED] received the remaining 50% of the commission generated in the accounts of EH and MW.

By reason of the foregoing, [REDACTED] violated NASD Conduct Rules 3010 and 2110.

THIRD CAUSE OF COMPLAINT
(Deficient Supervisory System – [REDACTED])
(Violations of NASD Conduct Rules 3010(a) and 2110)

27. Paragraphs 1 through 26 are re-alleged and incorporated herein by reference.

28. At all times relevant to this complaint, including from on or about October 4, 2002 through on or about December 19, 2002, [REDACTED] acting through [REDACTED] was required, pursuant to NASD Conduct Rule 3010(a) to establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with NASD's Rules.

29. On or about October 4, 2002, [REDACTED] hired Matz and [REDACTED] and approved the opening of the Melville, New York office of [REDACTED] being the sole principal on-site, at that office, responsible for supervision at that office.

30. As described in paragraph 26 above, the more commissions generated by Matz, the more commission received by [REDACTED] and by [REDACTED]. From on or about October 4, 2002 through on or about December 19, 2002, the trading in EH's and MW's accounts generated commissions of approximately \$277,042.94

31. During October 2002, [REDACTED] was designated as [REDACTED] supervisor on [REDACTED] supervisory structure list.

32. In or around October 2002, [REDACTED] authorized the transfer of approximately 100 accounts from the main office of [REDACTED] located in Birmingham, Alabama, to the Melville office, including the accounts of EH and MW.
33. In October 2002, at the time when both Matz and [REDACTED] first became employed with [REDACTED] had one disciplinary action on his Form U-4. On or around December 23, 1997, the State of Iowa ordered [REDACTED] to cease and desist from acting as an unregistered agent in the state of Iowa. From on or about August 29, 1994 through August 25, 1995, [REDACTED] was registered as a GSR through Stratton, a firm that was expelled from membership in or around December 1996 and which numerous state regulators have taken action against. Between December 1993 and the present, [REDACTED] has been registered with ten broker-dealers.
34. In or around October 2002, at the time that [REDACTED] hired Matz and [REDACTED] to operate the Melville office and at the time that he transferred the accounts to the Melville office, [REDACTED] was aware of Matz's and [REDACTED] prior disciplinary histories, customer complaint histories and employment backgrounds, as set forth in paragraphs 23-24 and 33 above. Despite their disciplinary histories, [REDACTED] decided not to place Matz on heightened supervision.
35. [REDACTED] hired Stuart Smith ("Smith") as chief compliance officer for [REDACTED] in or around March 2002. Prior to then, [REDACTED] was the chief compliance officer of [REDACTED]. When [REDACTED] hired him, Smith had only two years of securities related experience, no previous experience selling stocks and no prior compliance experience. Smith first became registered with NASD as a GSR through a member firm on or about

May 9, 2000. [REDACTED] was aware of Smith's lack of prior experience and was Smith's direct supervisor.

36. During this period, [REDACTED] was responsible for establishing and maintaining a system to supervise the activities of each registered representative and associated person reasonably designed to achieve compliance with applicable securities laws and regulations, and with NASD's Rules. Although [REDACTED] may have designated Smith, the chief compliance officer, as the individual responsible for establishing and maintaining the supervisory system at [REDACTED] his delegation of that responsibility was unreasonable in light of Smith's lack of experience and inability to fulfill that task.
37. Even after [REDACTED] unreasonably delegated supervisory responsibilities to Smith, he failed to review that delegated authority to ensure that it was being properly exercised. Had [REDACTED] done so, he would have known that the delegated authority was not properly being exercised. Among other things, Smith communicated to [REDACTED] that he needed help and was overwhelmed by his duties. In addition, in his normal course of review, [REDACTED] should have known that Smith's performance was deficient and that his delegation to Smith was unreasonable.
38. [REDACTED] acting through [REDACTED] failed to establish and maintain an effective supervisory system that would have enabled [REDACTED] to comply with the federal securities laws and NASD's Rules and to detect and prevent the conduct alleged above. Among other things, (i) there were no procedures in place at [REDACTED] under which turnover ratios or other measures of account activity could be considered; (ii) pursuant to the written supervisory procedures ("WSPs"), Smith reviewed all securities transactions conducted at the firm on a daily basis but had no guidance on

what he was to look for and there were no guidelines set up in the WSPs on what the review should entail; (iii) the WSPs were not reasonably designed to prevent and detect the churning in EH's and MW's accounts; (iv) there was no system at [REDACTED] to flag large trades; (v) there had been no discussion at [REDACTED] by [REDACTED] about placing Matz on "heightened supervision," despite his prior disciplinary, complaints, and employment history; (vi) [REDACTED] did not receive exception reports; (vii) [REDACTED] did not send out activity letters; (viii) the WSPs only provided for an annual review of the Melville office, which was not sufficient to detect improper trading activities at that office.

39. From on or about October 9, 2002 through on or about December 19, 2002, the supervisory system at [REDACTED] failed to detect sales practice violations occurring in the accounts of EH and MW. Although EH's and MW's investment objectives were capital appreciation, the supervisory system did not detect that the frequency of the trading in the accounts was inconsistent with those objectives. The turnover ratios and cost-to-equity ratios in the accounts of EH and MW were extremely high and indicative of irregularities. By on or about October 9, 2002, there had been approximately fifteen trades conducted in EH's account and on or about October 10, 2002, approximately twenty-eight trades were executed in EH's account. On or about October 15, 2002, approximately sixteen trades were conducted in MW's account. The size and frequency of the trades were not detected by [REDACTED] inadequate supervisory system that should have alerted [REDACTED] of potential problems in those accounts.

40. A regular monitoring of the operating account should have alerted [REDACTED] of irregularities in the trading patterns at the firm and should have led the firm to investigate the source of the higher commission income. In addition to Smith, [REDACTED] reviewed daily order tickets and commission runs for the accounts. Further, [REDACTED] was reviewing [REDACTED] operating account at least on a weekly basis, if not more often. The operating account included commission proceeds received from [REDACTED] clearing firm. Similarly, a review of the order tickets and commission runs should have alerted [REDACTED] of irregularities in the trading activity in EH's and MW's accounts. Despite these reviews by [REDACTED] and Smith, the supervisory system at [REDACTED] was so inadequate that the reviews by [REDACTED] and Smith were insufficient to spot trading irregularities, including the large spike in commission amounts and the number of trades executed in the accounts of EH and MW.

By reason of the foregoing, [REDACTED] and [REDACTED] violated NASD Conduct Rules 3010(a) and 2110.

PRAYER FOR RELIEF

WHEREFORE, Complainant respectfully requests:

- A. Findings of fact and conclusions of law that [REDACTED] Matz, [REDACTED] and [REDACTED] committed the violations charged and alleged herein;
- B. An order imposing sanctions upon [REDACTED] Matz, [REDACTED] and [REDACTED] in accordance with NASD Procedural Rule 8310;
- C. An order requiring [REDACTED] Matz, [REDACTED] and [REDACTED] to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest;
- D. An order imposing such costs of any proceeding as are deemed fair and appropriate under the circumstances in accordance with NASD Procedural Rule 8330; and

E. An order imposing any other fitting sanction.

Dated: May 26, 2005

DEPARTMENT OF ENFORCEMENT

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