BEFORE THE SECURITIES COMMISSIONER
OF THE STATE OF DELAWARE

IN THE MATTER OF:	)	
	)	
FLETCHER KING, and	)	**Case No. 01-6-1**
MORGAN STANLEY DW,	)	
	)	
Respondents.	)	

OPINION AND ORDER

Based on the evidence presented at the hearing held on February 8, 9, and 10, 2006, and the applicable law, the Hearing Officer makes the following findings of fact and conclusions of law:

A. Summary of Evidence and Findings of Fact.

1. On February 18, 2005, the Delaware Division of Securities ("Division"), a unit within the Delaware Attorney General's Office, filed an administrative complaint with the Securities Commissioner against Fletcher King and Morgan Stanley DW, Inc. ("Morgan Stanley") setting forth two counts for alleged violations of the Delaware Securities Act (6 Del.C. §§ 7302, *et seq.*). In the first count, the Division alleged that in August and September of 2000, the respondents recommended and sold certain mutual fund shares tc , a Delaware resident, without a reasonable basis to believe that they were suitable and without sufficiently communicating to Ms. the risks associated with the shares. The complaint alleged these recommendations and sales constituted a violation of 6 Del.C. §7316(a)(7) and §§ 609(b)(3), 609 (b)(24), and 609(c)(12) of the Rules and Regulations Pursuant to

the Delaware Securities Act. In the second count, the Division alleged that Respondent Morgan Stanley failed reasonably to supervise Respondent King in connection with his recommendation and sale of those mutual fund shares to Ms. . The complaint alleged this failure to supervise is in violation of 6 Del.C. § 7316(a)(7) and § 7316(a)(10).

2. Respondent Fletcher King is, and was at all times relevant to the matters at issue in this proceeding, employed as a broker-dealer agent of Respondent Morgan Stanley Dean Witter ("Morgan Stanley"). (Hearing Transcript ("Tr.") I at 195.) [1]

3. In March of 2000, Ms met with Mr. King at his office in Wilmington, Delaware, and opened an account with Morgan Stanley. (Tr. I at 104-105.)

4. At that time, Ms. was sixty four years old. She was divorced and had four adult daughters, one of whom was periodically living with her. (Tr. I at 80-81, 123.)

5. She was retired from full-time employment at the DuPont Company as a contract administrator and was working part-time for a local library. (Tr. I at 125-26.)

6. She owned investments valued at approximately $234,000.00 ($194,000.00 in a securities account at Merrill Lynch and $40,000.00 in certificates of deposit at a federal credit union). (Tr. I at 99, 183.) She also owned a condominium valued at approximately $50,000.00, which she used as her residence. (Tr. I at 184.)

7. Ms annual income, at the time that she opened her account at Morgan Stanley, was approximately $20,000.00, which she derived from Social Security benefits, her part-time employment, and her investments. (Tr. I at 124, 181.)

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[1] Transcript of hearing on February 8, 2006, is designated "Tr. I"; hearing on February 9, 2006 is "Tr. II"; and hearing on February 10, 2006 is "Tr. III."

After paying her necessary monthly expenses, she had no substantial income remaining to accumulate in a savings or investment account. (Tr. I at 125.)

8. Ms was an unsophisticated investor. She had no formal education or experience in the areas of investment or finance. (Tr. I at 82-93.) Although she had a pre-existing investment account at Merrill Lynch, she claimed to have little knowledge of the nature of her investments and minimal involvement in the activity occurring in her account. (Tr. I at 95.) Further, Ms was an infrequent consumer of financial information. (Tr. I at 85.)

9. At the time that she opened her account at Morgan Stanley, and before any investments were made in her account, Ms advised Mr. King that she would like to see her investments grow and she wanted investments that were conservative. (Tr. I at 107-111, and 113-14.) She testified that she emphasized to Mr. King that the money she was investing was for her retirement and it was all the money she had to live on. (Tr. I at 107.) She testified it was particularly important to her that her money be placed in safe investments, because she did not want to be put in a position where she would have to become dependent upon her daughters. (Tr. I at 144.)

10. On or about August 25, 2000, Mr. King recommended and sold the following mutual fund shares to Ms. (1) 2,039.984 class B shares of Morgan Stanley Dean Witter Total Return Trust at $24.51 per share for a total cost of $50,000.00, (Division's Ex. 40); (2) 753.693 class B shares of Morgan Stanley Dean Witter Information Fund at $33.17 per share for a total cost of $25,000.00, (Division's Ex. 40); and (3) 601.251 class B shares of Morgan Stanley Dean Witter Mid-Cap Equity Trust at $41.58 per share for a total cost of $25,000.00, (Division's Ex. 40).

11. On or about September 1, 2000, Fletcher King recommended and sold to Ms 292.201 class B shares of Putnam Global Equity at $18.14 per share for a total cost of $5,300.53. (Division's Ex. 40.)

12. On or about September 6, 2000, Fletcher King recommended and sold the following mutual fund shares to Ms : (1) 622.933 class B shares of Putnam Global Equity at $18.14 per share for a total cost of $11,300.00, (Division's Ex. 40); and (2) 2,923.698 class B shares of Morgan Stanley Dean Witter Equity Fund at $13.63 per share for a total cost of $39,850.00, (Division's Ex. 40).

13. Mr. King stated that he believed in the appropriateness of each of his mutual fund recommendations for Ms . (Tr. I, 283:12-15, 286:6-10, 287:24-288:6, 291:7-10.)

14. Mr. King testified as to some of the features of each of the mutual funds at issue, as they existed in August 2000, and his reasons for recommending them to Ms. . (Tr. I, 279:11-291:10.) Mr. King was at least somewhat knowledgeable about the particular funds he recommended to Ms . (Tr. I, 279:11-291:10.) He reviewed the prospectuses, studied the Morningstar reports, attended seminars and presentations by several of the funds' managers, and had conversations with some of the managers of the funds. (Tr. I, 280:11-281:4, 285:15-286:5; Tr. II, 88:15-89:8.)

15. After conducting this due diligence, Mr. King recommended five mutual funds, each with a four or five star Morningstar rating, comprised of large cap stocks, and with objectives of growth and income. (Tr. I, 279:11-291:10; Tr. III, 171:6-178:12; Ex. 12, 16, 19, 22, 547.) However, the Morningstar rating system did not mean that the funds with more stars were any safer than other funds. (Tr. I at 317).

16. Mr. King did not solicit Ms ; she initiated contact with him after a neighbor recommended him to her. (Tr. I, 139:22-140:5.) Mr. King met with Ms. and her companion ("Dr. "), face-to-face on two occasions before he made any recommendation to her. (Tr. I, 253:10-23.)

17. Mr. King testifed that at their first meeting on March 8, 2000, they discussed Ms prior investment experience at Merrill Lynch (Tr. I, 238:4-17), her reasons for transferring to Morgan Stanley (Tr. I, 166:9-16, 224:1-11, 227:9-17), her financial resources and needs (Tr. I, 166:17-167:24, 241:23-242:14), her risk tolerance (Tr. I, 165:6-17, 166:1-6), and her investment objectives (Tr. I, 227:15-17, 235:13-237:1). Mr. King testified he recorded a summary of this information on the new account form required by Morgan Stanley. (Ex. 84.)

18. Mr. King testified that, from this meeting, he learned that Ms had an account with Merrill Lynch prior to coming to Morgan Stanley. (Tr. I, 238:4-17.) She owned both equity and fixed income mutual funds at Merrill Lynch. (Tr. I, 242:21-243:6.) She left Merrill Lynch because her agent there became ill, and her monthly income payments from Merrill Lynch became irregular. (Tr. I, 224:1-11, 227:9-17, 243:4-6.)

19. Mr. King testified Ms expressed to him a desire for growth during their March meeting. (Tr. I, 148:13-18, 224:1-11, 227:9-17.) At the same time, she expressed a desire for conservative investments. (Tr. I at 114, 163-64). Mr. King's contemporaneous handwritten notes of the March 8 meeting summarized Ms. comments about her Merrill Lynch account as: "Unhappy. No growth + not responsive. Need to grow LT [long term]." (Ex. 520, at MSDW-D 0228.)

20. Mr. King believed these funds could be invested in growth mutual funds for the next five to ten years. (Tr. I, 224:12-225:3, 241:17-22.) Aside from the monthly $800 distribution from her account, he thought Ms. had no other need for these funds in the short term. (Tr. I, 125:1-8, 241:23-242:14.) Ms. had no dependents, no significant debts, or credit card bills. (Tr. I, 122:14-123:22)

21. Five months later, Mr. King and Ms met again to discuss investing with Morgan Stanley. Mr. King testified that again Ms mentioned "growth" at their August 22, 2000 meeting. At this time, the market had become extremely turbulent. (Tr. I, 258:17-259:22, 262:18-23.) Ms. did not remember this turbulence being discussed. (Tr. I at 129).

22. At that second meeting, in August of 2000, before recommending any securities for Ms. account, Mr. King revisited with her the investment strategy they had discussed previously and then made particular fund recommendations. (Tr. I, 258:17-259:12; Ex. 520, at MSDW-D 0075.) Mr. King testified that he presented her with an asset allocation chart detailing the transactions he proposed and discussed the level of risk associated with them. (Tr. I, 244:20-245:20, 263:11-264:16; Ex. 50.) Mr. King suggested that Ms hold one of the funds she transferred from Merrill Lynch, rather than selling it and incurring charges and fees. (Tr. I, 267:20-268:19.)

23. Ms. companion, Dr. , was also present at the August meeting, and, in no uncertain terms, he urged Ms to invest conservatively, in fixed-income securities. (Tr. I, 243:19-244:12.) Mr. King perceived Dr. as belligerant and tried to exclude him from the meeting, as he had at the earlier meeting in March. (Tr. I at 222). Mr. remained at Ms request, however. (Tr. I at 261). Thus, Ms was presented with two starkly different investment proposals, one consisting entirely of fixed income (per Dr. suggestion) and one

consisting entirely of equities per Mr. King's recommendation. (Tr. I, 261:20-265:8.) At Mr. King's urging, Ms. chose to buy the securities recommended by Mr. King and reject the more conservative approach suggested by her companion. (Tr. I, 262:4-21.) She trusted Mr. King. (Tr. I at 115).

24. Mr. King advocated what he viewed as a long-term investment strategy—one intended to satisfy Ms. immediate monthly cash flow needs but also to provide the potential for growth after ten years. (Tr. I, 244:20-245:16.)

25. Mr. King testified he explained to Ms. that she could expect to see short-term fluctuations in the value of her investments, but that these were investments intended for the long run, creating growth. (Tr. I, 244:20-245:16, 289:11-290:5.)

26. Mr. King claims he was careful to explain to Ms the risks associated with investing, in general, as well as the particular risks associated with the specific mutual funds he recommended. Mr. King claims he did not simply talk about risk in the abstract; he created a visual aide, in the form of a hand drawn cube, or "matrix," for Ms. that plainly showed the increasing volatility of funds as they move from value to growth, from the Dow Jones to the Nasdaq, from large cap to small cap, and from domestic stocks to those of developing countries. (Ex. 5; Tr. I, 228:10-233:19.) Mr. King's matrix did not include any bonds or other fixed-income investments, however. Ms. did not recall Mr. King quantifying for her how risk could impact her account. (Tr. I at 116-17).

27. Mr. King testified his "risk cube" was later used to create an asset allocation chart presented to Ms at the August meeting, which placed Mr.

King's particular investment recommendations into the relative sectors of the risk matrix. (Ex. 50; Tr. I, 263:11-265:8.) This tool was intended to create for Ms a visual demonstration of the relative risks of the various mutual funds she purchased. (Ex. 50.) She did not remember this discussion. (Tr. I at 170-71).

28. The asset allocation chart stated that the portfolio proposed by Mr. King contained zero percent fixed income. (Ex. 50.) Ms. did not notice this notation until her subsequent interviews with the Division. (Tr. I, 171:10-172:12.)

29. Mr. King testified he also provided Ms with other written materials that included information about the risks and features of those investments. At the August meeting, he gave Ms. Morningstar reports for each of the five funds he recommended. (Tr. I, 168:11-169:2.) Those Morningstar reports indicated that the funds consisted entirely of equities and did not contain any fixed income securities. (Ex. 12, 16, 19, 22, 547.) Ms testified that she did not read or understand them. , Tr. I at 117-19, 163).

30. Ms also received the mutual fund prospectuses, which disclosed the risks for each fund. (Tr. II, 84:6-10; Tr. III, 184:18-185:18.) They disclosed that the mutual funds were invested in the stock market, which is risky and can fluctuate.

31. Each mutual fund in which Mr. King purchased shares for Ms. had an investment objective of growth (with two funds, Morgan Stanley Dean Witter Total Return Trust and Morgan Stanley Dean Witter Equity Fund, also having an investment objective of income) and had holdings consisting primarily of stocks. (Division's Exhibits 55, 57, 58, 59, and 60.)

32. Three of the mutual funds (Morgan Stanley Dean Witter Information Fund, Morgan Stanley Dean Witter Total Return Trust, and Morgan Stanley Dean Witter Mid-Cap Equity Trust) had a beta coefficient (at July 31, 2000) of 1 or greater, indicating that shares in those funds were either as volatile or more volatile than the general stock market. (Division's Exhibits 12, 19, and 22.)

33. After her investment with Morgan Stanley in August 2000, Ms. observed the value of her portfolio plummet dramatically over the next eight months. She then sold her funds at a loss. (Tr. I, 301:19-302:13.) In a letter dated April 17, 2001, she directed Mr. King to transfer all her assets into a money market fund. (Ex. 27). On August 31, 2000, the balance in her Morgan Stanley account was $ 199,161.75 as a result of transfers from Merrill Lynch. (Ex. 40). At the end of April 2001, she liquidated her Morgan Stanley account and received $118, 660.72. (Ex. 34, 35). Thus, she had lost $80,501, which was 40% of her money.

Morgan Stanley's Supervisory System and Personnel.

34. In 2000, Morgan Stanley had a supervisory system in place to try to ensure that financial advisors recommended suitable investments and adequately disclosed the risks of those investments to their customers. (Scott II, 31:10-32-3.) That supervisory system included, among other things, the use of new account forms, trade activity reports ("TARs"), mutual fund switch letters, supervisory logs, financial advisor training, compliance manuals, daytimers, correspondence reviews, regular compliance meetings, and informal meetings between supervisory personnel and financial advisors. (Ex. B; Scott II, 32:16-37:14.) Every month, each of Morgan Stanley's branch offices, including

its Wilmington branch office, was required to submit a branch manager's supervisory log certifying that it complied with this supervisory regimen. (Ex. 521; Scott II, 60:5-64:14.)

35. Mr. Rodney Scott was the branch manager of Morgan Stanley's Wilmington branch from December 1983 to May 2005, and had supervisory responsibility for Mr. King during the events in question. (Scott II, 25:22-26:12, 13:6-11.) Mr. Scott has more that 35 years of experience in the brokerage industry and has served on the NASD Business Conduct Panel. (Scott II, 25:13-17, 28:6-13.) Mr. Scott was assisted in his supervisory role by other licensed personnel who were physically located in the Wilmington branch. (Scott II, 32:4-15.)

36. Ms. complaint was the first and only customer complaint that Mr. Scott ever received about Mr. King. (Scott II, 65:16-19.)

Morgan Stanley's New Account Forms.

37. Morgan Stanley required financial advisors to complete a detailed new account form and obtain supervisory approval before opening a new account. (Ex. 84, Scott II, 38:11-40:1.) This forced financial advisors to ask customers questions about their financial condition, investment experience and investment objectives. (Ex. 84; Scott II, 40:16-22.)

38. Customers' investment objectives (as recorded on the Morgan Stanley new account form) reflect their risk tolerances to a limited extent. (Scott II, 41:16-43:7; Corrigan III, 193:19-198:23.) For example, a customer with the investment objective of aggressive income has a higher risk tolerance than a customer with the investment objective of income. (Scott II, 41:16-43:7; Corrigan III, 193:19-198:23.) A customer

with the investment objective of speculation has a higher risk tolerance than a customer with the investment objective of capital appreciation. (*Id.*) And a customer with the investment objectives of both income and capital appreciation has a higher risk tolerance than an investor who has the sole investment objective of income. (*Id.*)

39. Brokerage firms are not required to record customers' risk tolerances separately from their investment objectives, and many brokerage firms, including Morgan Stanley, do not do so.[2] (Corrigan III, 198:24-199:10.) Morgan Stanley's new account forms are reviewed annually by the NYSE and NASD, and there was no evidence that those organizations have ever found Morgan Stanley's forms to be inadequate or inappropriate. (Corrigan III, 198:24-199:10.)

40. Mr. King completed a new account form during his initial meeting with Ms on March 8, 2000. (Ex. 84; King I, 233:20-234:9.) Ms. new account form recorded her investment objectives as income and capital appreciation, and recorded information regarding her financial condition and investment experience. (Ex. 84; Corrigan III, 169:6-170:6; I, 180:13-184:12.)

41. Exhibit 83 is a printout from Morgan Stanley's Merlin system. (Ex. 83; Scott II, 22:17-23:6.) Exhibit 83 suggests that Ms. primary investment

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[2] As the Division argued, this industry practice of merging a customer's risk tolerance with the investment objective on new account forms is far from optimum. It causes confusion and miscommunication, which I believe occurred in this case. (Ms. apparently did not realize that by saying she wanted some growth, she was then viewed as having substantial risk tolerance.) It is, however, a practice that is tolerated by the SEC and the NASD, agencies with primary responsibility for regulating our national securities markets. States are preempted under Federal law from attempting to prescribe broker-dealer recordkeeping practices. *See* National Securities Markets Improvement Act of 1996, § 103; 15 U.S.C. § 77o(h)(1).

objective was income, with capital appreciation listed as another investment objective. Morgan Stanley claims Exhibit 83 is erroneous because Ms. new account form did not prioritize her investment objectives. (*Compare* Ex. 83 *with* Ex. 84; Scott II, 44:16-47:3.) The branch manager, Mr. Scott, testified he placed no reliance on Exhibit 83 in supervising Ms. account, and instead relied on the new account information contained in Exhibit 84. (Scott II, 43:14-44:4.)

Morgan Stanley's TARs.

42. Rodney Scott, Mr. King's branch manager, testified that supervisors in the Wilmington branch reviewed TARs daily to try to ensure that all customer transactions were suitable. (Ex. 502; Scott II, 16:3-19, 47:7-48:17; Corrigan III, 189:23-193:8.) The TARs identified, among other information: the financial advisor, the customer, the type of account, the customer's age, income, liquid assets, net worth, and investment objectives, and all of the transactions in the customer's account that day. (Ex. 502, Scott II, 51:5-53:15; Corrigan III, 189:23-193:8.) Because customers' investment objectives reflect their risk tolerances to a limited extent, the TARs also provided supervisory personnel with some information regarding customers' risk tolerances. (Scott II, 41:16-43:7; Corrigan III, 193:19-198:23.)

43. Mr. Harold Corrigan, an expert witness for Respondent Morgan Stanley, testified that Morgan Stanley's TARs "were the best report on Wall Street at that time." (Corrigan III, 189:23-190:14.) In 2000, Morgan Stanley was the only brokerage firm that included investor profile information on its daily trade activity reports, including customers' age, income, liquid assets, net worth, and investment objectives. (Corrigan

III, 190:15-192:7.) The majority of brokerage firms still do not include this information on their daily trade activity reports. (Corrigan III, 192:1-7.)

44. The TARs covering Ms. transactions were reviewed by a licensed supervisor in the Wilmington branch. (Scott II, 53:16-54:2.) Those TARs did not generate any red flags because the transactions described therein--the purchase of five brand name mutual funds--were consistent with Ms. recorded investment objectives of income and capital appreciation. (Scott II, 53:16-55:9; Corrigan III, 170:7-178:12.)

Morgan Stanley's Mutual Fund Switch Letters.

45. Morgan Stanley automatically generated mutual fund switch letters when customers switched from one mutual fund family to another. (Ex. 519; Scott II, 55:10-58:13.) These one-page form letters identified the transactions at issue, and asked customers to acknowledge in writing that: (i) their financial advisor was authorized to enter into the transactions; (ii) they were fully advised regarding the expenses associated with the transactions and alternatives to the transactions, if any; (iii) they understood that mutual funds are considered long term investments; and (iv) the transactions were consistent with their investment objectives. (Ex. 519; Scott II, 56:15-60:4.)

46. On September 1, 2000, Morgan Stanley sent Ms two mutual fund switch letters regarding the now disputed transactions in her account. (Ex. 519; I, 159:7-23.) Ms. did as she was asked to do. She signed and returned both letters to Morgan Stanley. (Ex. 519; I, 159:7-23.)

47. The only expert testimony in this matter came from Harold Corrigan, who

opined that the securities sold to Ms. were suitable for her given her investment objectives, Morgan Stanley reasonably supervised Mr. King, and Morgan Stanley's supervisory system met or exceeded the industry standard at all times.[3] (Corrigan III, 165:3-16, 186:11-23.) Mr. Corrigan worked at Merrill Lynch for more than 35 years, and had supervisory responsibility for approximately 60 Merrill Lynch offices during his tenure. (Corrigan III, 154:13-156:19; Ex. 524.) He has also been elected to the NASD's District Committee for District 7. (Ex. 524.) Mr. Corrigan testified that he has reviewed, and is familiar with, the supervisory practices of all major brokerage firms except Goldman Sachs. (Corrigan III, 158:15-159:5; 162:10-24.)

[3] Mr. Corrigan also testified that Ms. prior portfolio (of bond funds) when her account was with Merrill Lynch was actually riskier than her portfolio (of equity funds) at Morgan Stanley. He stated that the "junk" status of high yield bonds meant they were below investment grade. He failed to explain how this made the Morgan Stanley portfolio less risky--in light of the fact that mutual funds invested in common stocks are also below investment grade bonds in quality. Mr. Corrigan admitted that he did not examine the relative price movements of the securities in each portfolio. (Corrigan, Tr. III at 210-14). He stated that he relied upon the fact that the betas of the high yield bond funds were higher than the betas of the equity mutual funds that Mr. King recommended. Mr. King himself testified that comparing the betas of equity and bond funds was like comparing "apples and oranges." (Tr. I at 317-19). (Beta is a measurement of the price volatility of a security relative to the market for that type of security). Mr. King also testified that there is some truth to the suggestion that bond funds are inherently safer than equity funds. (Tr. I at 319). For the foregoing reasons, I reject Mr. Corrigan's testimony on this point.

B. Discussion

1. Alleged suitability violation by Fletcher King.

a) The suitability doctrine generally.

The suitability doctrine has multiple sources, multiple rules, and multiple theories associated with it. It appears in different forms, with different required elements, in regulatory enforcement proceedings by the National Association of Securities Dealers, Inc. ("NASD"), the New York Stock Exchange ("NYSE"), and the United States Securities and Exchange Commission ("SEC"), and in state court common law claims and private fraud actions seeking damages in federal court. Its origin is in the evolution of general notions of conduct based upon agency and fiduciary principles.[4]

Under the doctrine of suitability, a broker is obligated to recommend only those securities he reasonably believes are suitable for the customer in light of the customer's financial needs and circumstances. The doctrine has different elements, depending on whether the claim is brought by an investor in a private lawsuit or by a government agency or a self-regulatory organization ("SRO"), such as the NASD or the NYSE, in a regulatory action. Generally, the federal courts have not recognized the NASD's ethical rules as a basis for a private damages action in that forum. Thus, what are deemed "suitability" cases in the federal courts are not based on the NASD's suitability rule but on § 10(b) of the Securities Exchange Act of 1934, and the SEC's Rule 10b-5. These

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[4] *See generally*, Poser, N., "Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors," 2001 B.Y.U. L. REV. 1493, 1527 (2001) ("Posner"); Rapp, R., "Rethinking Risky Investments for That Little Old Lady: a Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers," 24 OHIO N.U. L. REV. 189, 195 (1998).

actions are hardly different from other fraud actions, and these claims contain the same elements as fraud actions generally.[5]

However, these elements change in the context of an administrative action brought by a government agency or a self-regulatory organization (SRO), such as the NASD or the NYSE. An NASD suitability violation does not require scienter on the broker's part. *See Holland v. Securities and Exchange Commission,* 105 F.3d 665 (9th Cir. 1997) (table), 1997 WL 3625 at *2 (9th Cir.) (unpublished opinion); *Erdos v. SEC*, 742 F.2d 507, 508 (9th Cir. 1984); *In the Matter of District Business Conduct Committee for District No. 1 v. Daniel Wright Sisson,* 1998 WL 1084546 at *6 (N.A.S.D.R. Nov. 18, 1998); *In the Matter of District Business Conduct Committee for District No. 10 v. Rafael Pinchas*, 1998 WL 1084569 at *5 (N.A.S.D.R. June 12, 1998). The NASD's suitability rule creates a substantive requirement, in addition to the duty of full disclosure,

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[5] The Second Circuit Court of Appeals, for example, views a suitability violation, in the context of a private lawsuit, as a form of fraud under § 10(b) of the Securities Exchange Act of 1934. A suitability claim has the following elements: 1) the securities purchased were unsuited to the customer's needs; 2) the broker knew or reasonably believed the securities were unsuited to the investor's needs; 3) the broker recommended the securities to the customer anyway; 4) with scienter, the broker made material misrepresentations or omissions relating to the suitability of the securities, and 5) the customer justifiably relied to his or her detriment upon the broker's recommendation. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600-601 (2d Cir. 1978). In connection with the reliance element, the court stated that if an investor could have discovered the truth about the investment with minimal effort, the investor's reliance on the broker's oral statements is unjustified. Similarly, if an investor is provided with a prospectus or other written materials that contradict the oral statements, the investor is not justified in relying upon the oral statements. *Brown, supra*, 991 F.2d at 1031-32. *But see Gochnauer v. A.G. Edwards & Sons, Inc.,* 810 F.2d 1042, 1050 (11th Cir. 1987) (federal securities laws addressing fraud claims do not supplant fiduciary principles under state law).

not to make a recommendation to the customer that is not in the customer's best interests. *See* Poser, *supra*, at 1529.

Moreover, the SEC and the NASD do not regard the delivery of a prospectus as relieving a broker of his responsibility for misrepresentations and omissions of material information with respect to a security being recommended. *See In re Larry Ira Klein*, Exchange Act Rel. No. 3785 (October 17, 1996); *In the Matter of District Business Conduct Committee District No. 10 v. William J. Lucademo*, 1997 WL 1121318 at *16 (N.A.S.D.R. 1997).

b) Delaware Securities Division Rule 609.

The Securities Division has charged Mr. King under a subsection of the Delaware Securities Act, 6 Del.C. § 7316(a)(7), that prohibits "dishonest or unethical practices" by a broker-dealer or its registered agent. Pursuant to this provision, the Delaware Securities Commissioner has promulgated Rules and Regulations Pursuant to the Delaware Securities Act ("Rules"). Rule 609 provides a detailed interpretation of what constitutes "dishonest or unethical practices." Mr. King was charged with violating Rule 609(b)(3), (b)(24), and (c)(12). Rule 609(b)(3) states the following:

> (b) Broker-Dealers. For the purposes of 6 Del.C. § 7316(a)(7), dishonest or unethical practices by a broker-dealer shall include, but not be limited to, the following conduct:
>
> (1) * * *
>
> (2) * * *
>
> (3) Recommending a transaction without reasonable grounds to believe that such transaction is suitable for the customer in light of the customer's

> investment objective, level of sophistication in investments, financial situation and needs, and any other information material to the investment.

Although Rule 609(b)(3) on its face applies only to broker-dealers, it is applicable to registered broker-dealer agents (such as Mr. King) through Rule 609(c)(12), which states that agents are subject to the rules in paragraph (b) of Rule 609. Subsection 609(b)(24) states that broker-dealers must conduct a reasonable inquiry into the risks of a recommended investment and communicate those risks in a meaningful way to the investor.

The current administrative Rules were adopted on May 6, 1998. *See* Walker, C., "Delaware's Response to the Increased Enforcement Responsibilities of State Securities Regulators: A Comprehensive Revised Regulatory Scheme," 2 DEL. L. REV. 19, 45 (1999).

The Securities Division's Rule 609 parallels the NASD's current rule on suitability--Rule 2310 of the NASD Conduct Rules, which states as follows:

> 2310. Recommendations to Customers (Suitability)
> (a) In 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.

NASD Manual (2003). The similarity of the Delaware rule and the NASD's rule suggest that the Delaware standards are highly similar to the NASD's. Indeed, prior Delaware case law explicitly relied on NASD standards.

c) The *Flowers* test.

Prior to the adoption of the current Rules, the Delaware Securities Division explicitly relied upon the ethical rules (known as "Rules of Fair Practice") of the National Association of Securities Dealers, Inc. ("NASD") to interpret 6 Del.C. § 7316(a)(7). In *Flowers v. Hubbard*, 1991 WL 216094 (Del.Ch. 1991), the Delaware Court of Chancery entertained an appeal of a disciplinary action by the Securities Commissioner against a broker-dealer agent who had been sanctioned for suitability violations. The Court of Chancery affirmed the Commissioner's order, thus affirming the Division's reliance upon the NASD's ethical rules.[6]

Under the standard of *Flowers v. Hubbard*, 1991 WL 216094 (Del.Ch. 1991), a suitability violation exists where a broker either (1) does not believe in good faith that the investment being recommended is appropriate for the client, or (2) the broker has failed to take steps to inform himself of the nature and prospects of the investment.

In *Flowers,* Chancellor Allen did not purport to address all obligations owed by broker-dealers towards their clients. To the contrary, he noted that "[d]ealers in securities have a variety of duties towards those persons to whom they sell securities." *Id.* at *3. The context of *Flowers* was a non-discretionary account where the brokers had not assumed any broader fiduciary obligations.

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[6] Also, in *Hubbard v. Hibbard Brown*, 633 A.2d 345 (Del. 1993), the Delaware Supreme Court affirmed revocation of broker-dealer agent licenses based in part on findings of violations of 6 Del.C. § 7316(a)(7), using the NASD Rules of Fair Practice as the ethical standards that were violated.

d) Key testimony.

Ms. testified that she told Mr. King she wanted prudent, conservative, and secure investments. (Tr. I at 114, 163-64). She said that, when asked by Mr. King if she wanted some growth, she said yes. (Tr. I at 148). However, growth was not important to her. Safety of principal and income were her primary investment goals. (Tr. I at 113, 148, 164).

Mr. King testified that he advised Ms. of the risks in the stock market. He said he gave her a prospectus and Morningstar report for each mutual fund, showed her a diagram of the continuum of risk across the universe of equity investments, and gave her a summary of his recommended portfolio showing zero per cent in fixed-income securities. When Mr. King was confronted by Dr. demands that her portfolio consist of fixed-income investments, Mr. King told Ms it was her choice as to which type of portfolio she wanted. She chose growth. (Tr. I at 262). Mr. King's notes support his version of events. (Ex. 4).

Although neither Ms nor Mr. King accused the other of testifying falsely, it is somewhat difficult to reconcile their testimony. Mr. King clearly did provide Ms with a prospectus and Morningstar report for each mutual fund, as well as a summary of her portfolio showing no fixed-income investments. She testified that she did not read them. (Tr. I at 163).

Mr. King also testified that Ms told him that she was afraid of running out of money while she was still alive in her 80s. (Tr. I at 141). Mr. King testified that Ms told him that she came from a family where the women

lived to be very old, and so she wanted long-term growth. (Tr. I at 224). This testimony appears false in light of subsequent testimony and Ms rebuttal testimony. Both Ms. and Ms (her daughter) testified that Ms. is not afraid of living to an old age, as she is the longest-lived woman in her family. (Tr. II at 94). Her mother died at age 28. (Tr. II at 133). Hence, it would be very unlikely she would make such statements as Mr. King claimed.

e) Miscommunication.

Miscommunication played a role in the creation of Ms portfolio. She told Mr. King about her neighbor's recommendation of him as a broker, mentioning that the neighbor said that her investments had grown by $90,000. (Tr. I at 142). This growth was not important to Ms. according to her testimony, nor did she seek to replicate it, but it may have assumed an importance in Mr. King's mind. The fact that Ms. mentioned it appears to have contributed to Mr. King's perception that growth was important to Ms .

This information was combined with the fact Ms. departed as a customer of Merrill Lynch, where she had a largely fixed-income portfolio. Mr. King testified that her dissatisfaction with the fixed-income portfolio played a role in causing his growth-oriented recommendation. (Tr. I at 243). She told him her Merrill Lynch portfolio had lacked growth. In her testimony, she admitted telling Mr. King that. (Tr. I at 148).

Also, Ms testified she told Mr. King she wanted to buy a two-bedroom condominium, a step up from the one-bedroom in which she lived. (Tr. I at

166). Such a purchase would have required additional money, and this fact would have suggested to Mr. King that Ms sought growth.

An additional factor is that Ms did not read the materials provided to her by Mr. King. She did not even read the asset allocation summary showing she had zero fixed-income investments. Had she been more diligent, it is likely she would have made her investment objectives more apparent to Mr. King.

Once growth was listed as her investment objective on the new account form, Morgan Stanley and Rodney Scott, the branch manager, would have reasonably viewed the portfolio of mutual funds as consistent with that objective.

f) The securities at issue.

On an "asset allocation chart," (State's Ex. 26), Mr. King recommended five mutual funds for Ms. to buy, and a sixth fund, which she had purchased at Merrill Lynch, to keep. The five funds he recommended were: 1) Morgan Stanley Dean Witter ("MSDW") Information B,[7] 2) MSDW Equity B, 3) MSDW Total Return B, 4) MSDW Mid-Cap Equity B, and 5) Putnam Global Equity B. The sixth fund he recommended she keep from her Merrill Lynch portfolio was Davis NY Venture B. The chart shows a concentration in the securities of "large cap" growth companies.[8] The amount of money allocated to each fund in the chart was as follows:

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[7] The "B" designation indicates a contingent deferred sales charge, or "back end load," which is generally a sales fee of 4 or 5 per cent of the value invested. These back end loads are generally waived, at least in part, if the funds are held by the investor for a sufficiently long period.

[8] "Large cap" refers to large capitalization, or companies whose market capitalization (stock price times number of shares) is large, generally over five or ten billion dollars.

MSDW Information B	$25,000
MSDW Equity B	50,000
MSDW Total Return B	50,000
MSDW Mid-Cap Equity B	25,000
Putnam Global Equity B	25,000
Davis NY Venture B	25,000
	$ 200,000

However, the actual purchases did not exactly follow this chart. The investments in the Total Return fund, Information fund, and Mid-cap Equity fund did follow the recommendations in the chart. However, slightly less than $40,000 was invested in the MSDW Equity fund, and about $11,000 was invested in the Putnam Global Equity fund.

Mr. King contends, and Ms. testified he told her, that these funds were suitable for her because they were high quality, well-diversified investments. Ms. also contends Mr. King said they were "secure."

In my opinion, these mutual funds were not well diversified and they were not "secure" investments.[9] However, my personal opinion about these securities is not evidence and is thus an insufficient basis for me to find a violation of the law. My task as a hearing officer is to weigh the evidence presented by each side. There must be a preponderance of evidence supporting the Division's position that these securities were too risky and unsuitable for Ms. as a matter of law. The respondents presented expert testimony that these securities were not too risky or unsuitable for her. No testimony was presented by the Securities Division as to the riskiness of these securities.

[9] The 1997 Merriam-Webster Dictionary defines "secure" as: (1) easy in mind, free from fear, and (2) free from danger or risk of loss.

Investing is a complex area in which theories are constantly evolving. Even for fiduciaries, there are few bright-line standards for determining suitability. The traditional "prudent investor" rule has been relaxed in recent years in light of modern portfolio theory.[10] Using modern financial theory, a discussion of the riskiness of a portfolio should include the topics of diversification and the covariance of the volatility of the various assets with each other and the market.[11]

Judging from the bad results for Ms , it is apparent that the funds were risky. Ms testified, however, that she was willing to take some risk with her investments. Her objection was to the extent of the risk with these mutual funds. (Tr. I at 166). The suitability issue here is not whether the investments were risky, but whether their degree of risk was sufficiently evident--at the time of the investment--that the broker lacked reasonable grounds for the recommendation. If one looks at the price charts of these funds in the Morningstar reports for the years immediately prior to 2000, there is no indication of the degree to which they could drop. (Ex. 11, 12, 16, 19). The fact that an investment lost money is insufficient to infer a lack of suitability. *Alton ex rel. Alton v. Prudential-Bache Securities, Inc.*, 753 F.Supp. 39, 43 (D.Mass. 1990). Even in the fiduciary context, a fiduciary is not necessarily legally responsible for investment losses due to the bursting of a market bubble.[12]

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[10] *See* Dobris, J., "Speculations on the Idea of 'Speculation' in Trust Investing: An Essay," 39 REAL PROP. PROB. & TR. J. 439, 449-51(2004); REST. 3d TRUSTS-PIR § 227 Comment (e) (1992) ("prudent investor rule" does not classify specific investments or courses of action as prudent or imprudent in the abstract).

[11] *See* Kerr, J., "Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy," 16 PAC. L.J. 805, 816-17 (1985); Rapp, *supra* n.4, at 250-52.

[12] *See* Dobris, *supra* n. 10, at 494.

To prevail in a case such as this, the Division must present either favorable precedent that is directly on point (particularly with respect to the nature of the securities at issue) or expert testimony supporting the conclusion the Division advocates. Here, it did not do either.

g) Applying the *Flowers* test.

There are two requirements under *Flowers*: good faith and due diligence. I find that Mr. King acted in good faith.[13] He believed that one of Ms. investment goals was growth, and he believed that the mutual funds he purchased for her were consistent with a growth objective and were relatively stable. There was no intent on his part to deceive Ms as to the nature of the investments he was buying for her. He provided her with a prospectus for each mutual fund and Morningstar reports that analyzed each. He gave her an asset allocation chart that showed she was investing totally in equities, with no fixed-income securities. He had no self-interested motive that has been shown by the Division to put her into equities as opposed to other types of investments.

The following facts tend to conflict with Ms claim that at all times she wanted conservative, prudent investments rather than growth and support the finding that Mr. King acted in good faith:

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[13] Even if I were to apply a negligence standard, on the grounds that Mr. King had implied discretionary authority over Ms account, I could not find for the Division. *See Bowley v. Stotler & Co.*, 751 F.2d 641, 644 (3d Cir. 1985); *Rupert v. Clayton Brokerage Company of St. Louis, Inc.*, 737 P.2d 1106, 1109 (Colo. 1987) (*en banc*); *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir. 1981); *Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817, 819-20 (6th Cir. 1981). The absence of evidence on the issue of the riskiness of the recommended securities is fatal to the Division's case.

1. By signing the Morgan Stanley mutual fund switch letters, she explicitly agreed that the recommended funds were consistent with her investment objectives.

2. She stated several times that she wanted growth.

3. She indicated a dissatisfaction with her Merrill Lynch portfolio, which was 60 % fixed-income investments, as lacking growth.

4. She rejected Dr. conservative, fixed-income oriented recommendation in favor of Mr. King's equities-oriented recommendation.

5. She testified that she knew at the time she invested with Morgan Stanley that fixed-income investments were relatively secure and the stock market fluctuated in value. (Tr. I at 164, 166, 191).

Viewed narrowly, Mr. King also met his due diligence obligation. He sufficiently examined the securities he was recommending to have some knowledge of their characteristics. In this sense, he met the test for some minimal level of research into and knowledge of the securities he was selling. Whether his evaluation of her investment objectives and his selection of securities to recommend were minimally competent is a more difficult issue. This issue turns on the riskiness of the securities selected, and there is no testimony on this point from the Division.

h) Prior cases applying the suitability rule.

The Division argues that a recommendation of a 100% equity portfolio to a 64-year old retiree with modest savings and limited income is inherently unreasonable. I asked the Division to provide authority that supports this theory, but the cases it cites do not provide such support.

The Division relies upon an NASD decision: *In the Matter of District Business Conduct Committee for District No. 1 v. Frederick M. Wooley,* 1996 WL 1114520 (N.A.S.D. October 23, 1996). It cites *Wooley* for the proposition that it is a broker's responsibility to determine a customer's tolerance for risk (regardless of the investor's chosen objective). It also cites *Wooley* for the proposition that before a broker may recommend an illiquid security to a customer, he must verify that the customer's investment objective is not safety of principal.

Wooley does not support the arguments that the Division has asserted here, at least as they apply to this case. The facts of *Wooley* are far different than the facts of this case. In *Wooley*, the investor consistently told the broker that safety of principal was paramount. Here, the investor rejected the investment goal of safety urged by her friend Dr in favor of a growth-oriented portfolio. In *Wooley*, the broker's records supported the investor's version that she wanted safety. Here, the broker's records support his version that the investor wanted growth.

In *Wooley,* the broker sold the investor a series of "Trudy-Pat" real estate income trusts ("REITs") that apparently had no marketability and stopped paying income, where the underlying collateral (real estate) was sold after foreclosure, making the trusts worthless. Here, the Division argues that highly liquid large cap equity funds are illiquid simply because there is a redemption fee. The existence of a redemption fee does not make a highly liquid security illiquid. The securities in this case are in no way similar to the "Trudy-Pat" REITs in *Wooley*. Mr. King did not recommend or sell an illiquid investment.

The Division also relies upon an SEC consent order: *In the Matter of NationsSecurities and NationsBank,* 1998 WL 214288 (S.E.C. May 4, 1998). The Division asserts that *NationsBank* stands for the proposition that a broker's failure to assess properly his customer's risk tolerance may lead to a finding of a suitability violation.

Putting aside the weakness of a consent order as precedent, the facts of *NationsBank* bear little similarity to those of the instant case. *NationsBank* is primarily a fraud case, where a commercial bank and its securities brokerage service acted jointly to deceive customers of the bank into thinking they were investing in safe securities backed by the United States government. In fact, they were investing in privately-created, uninsured term trusts that traded on the New York Stock Exchange and were subject to large swings in value due to interest rate risk. Due to the nature of the customer list employed by *NationsBank* (customers with maturing certificates of deposit), the investment objective of the customers appeared to be income with safety of principal. NationsBank, NationsSecurities and its brokers simply ignored the investment objective of the customers and lied to them about the characteristics of the securities at issue. On the topic of suitability, the Securities and Exchange Commission ("SEC") stated that "NationsSecurities failed to collect sufficient data on customer risk tolerance and investment horizon or failed to properly utilize the information that had been received." *Id.* at *9. The SEC also noted that the branch manager review system was structured in such a way that the branch manager did not review the new account form and trade ticket

until after the trade had been approved, which made the branch manager's review moot as a practical matter.

The customers in *NationsBank* were not on record as seeking growth in their investments. Neither Morgan Stanley nor Fletcher King has been accused of perpetrating a fraudulent scheme as NationsBank and its brokers employed in that case. There is no suggestion in this case that the branch manager failed to review the new account form and the trade ticket prior to approving the transactions for Ms.

The Division relies upon another SEC decision: *In the Matter of the Application of Charles W. Eye*, 1991 WL 286409 (S.E.C. August 15, 1991), for the proposition that "regardless of whether [the investor] appeared willing, or even eager, to pursue 'growth' as [the broker] understood it, it was [the broker's] duty to advise her against that pursuit to the extent it was incompatible with her acknowledged needs." Although the language here supports the Division's case, the facts of *Eye* do not. This language is *dicta,* for the fact-finders in this matter (the NASD district business committee) did not believe the respondent's assertion that the investor's goal was growth. To the contrary, the NASD found the following:

> Gary Robbins, an acquaintance of both Ramini [the investor] and Eye, called Eye to explain Ramini's new situation [divorced]. He reminded Eye that Ramini did not understand the fundamentals of investing and noted that she could not afford to risk the principal in her account. When Ramini met with Eye in late January to discuss a plan to meet her expenses, she issued a similar warning.

Id. at *1. The facts of *Eye* have little in common with the instant case: the broker invested the entirety of the investor's principal in a single commodity-related stock, Houston Oil Trust, and then proceeded to borrow money on her margin account to invest

in other highly risky individual stocks. With an account having a principal of only $90,000, the broker purchased $145,000 in individual, highly risky securities. At the same time, the broker lied to his client about what he was doing and engaged in unauthorized trades. The investor ended up losing about half her money.

In contrast, in the instant case, the broker recommended mutual funds, not individual securities. The individual stocks that comprised the funds were those of relatively high quality, large cap companies. The funds themselves were highly rated by Morningstar, the respected publication that rates most or all mutual funds. The investor was informed by the broker as to the strategy and each transaction, and complained only after the market went down. Snippets of *dicta* that in the abstract appear to support the Division's case are insufficient to persuade me there is authority for the discipline the Division proposes.

The same can be said for the Division's citation of *In the Matter of Paul F. Wickswat*, 1991 WL 288264 (November 6, 1991), and *In the Matter of the Application of Eugene J. Erdos,* 1983 WL 33908 (S.E.C. November 16, 1983). *Wickswat* involved a broker who engaged in highly leveraged, unauthorized trading and wrote naked put options where the investor's principal was insufficient to cover the possible exercise of those options. The account quickly dropped in value from $105,238 to $38,846. *Erdos* involved a broker who churned the investor's account, purchased options, borrowed money on margin, and sold stocks short. The investor was a 75-year old widow.

In sum, it appears that the Division is unable to find any precedent involving similar facts to this case where a suitability violation was found.

In retrospect, the portfolio that Mr. King recommended to Ms was--in my opinion--riskier than it should have been. A portfolio of 100% equity securities is not the typical recommendation for a retiree of modest means, nor should it be. A broker should anticipate that a client in such a position may not be able to tolerate the emotional stress of a large drop in the portfolio's value. I am certain that Mr. King did not anticipate the degree to which the market would decline, but he knew it was possible. Mr. King's view that these losses are just temporary was not helpful to Ms.

Ms. suffered a loss of $80,000, which was 40% of her money. For those invested in equities during the period of 2000-2001, these figures are typical. The Standard & Poors 500 Index lost 50% of its value, and the NASDAQ index lost more than 70% of its value.

The Division argues that Mr. King is the professional and must be held accountable for his bad recommendation. However, a broker is not strictly liable for the results of the recommended investment. *See, e.g., Alton ex rel. Alton v. Prudential-Bache Securities, Inc.,* 753 F.Supp. 39, 43 (D.Mass. 1990) (granting motion to dismiss complaint alleging failure to meet investment objectives where investment resulted in a loss).

2. Failure to communicate the risks of recommended securities.

Mr. King is charged with failing to communicate adequately the risks of the securities at issue. The record is clear that Mr. King provided Ms. with prospectuses and Morningstar reports for the recommended securities. Ms did not dispute that Mr. King discussed a "risk cube" or "risk matrix" with her. He also

gave her an asset allocation chart showing 100% equity investments. She knew the stock market fluctuated. She admits not remembering much of what was discussed between her and Mr. King. I find that the Division has not met its burden of proof on this charge.

3. Alleged failure to supervise violation by Morgan Stanley.

Morgan Stanley and its branch manager, Rodney Scott, adequately supervised Mr. King. Given that Ms investment objectives on the new account form included growth, the recommended mutual funds were reasonable for that objective. Although the new account form itself is subject to criticism, as the Division argued at the hearing, states are federally preempted from prescribing broker-dealer recordkeeping practices.

4. Expungement.

Mr. King's request that I order expungement of the CRD record of this matter is denied.

C. Conclusions of Law.

I conclude that the charges against both Respondents, Mr. King and Morgan Stanley, lack merit and should be dismissed.

IT IS ORDERED that the charges against the Respondents are hereby dismissed.

Richard W. Hubbard
Hearing Officer

Dated: September 15, 2006