

FILED

JOHN A. TOMASINO

MAR -6 2014

CLERK, SUPREME COURT

BY _____

APPENDIX D



NEWS RELEASE

For Release: June 4, 2012
Contacts: Michelle Ong (202) 728-8464
Nancy Condon (202) 728-8379

Brookstone Securities, Inc., Antony Lee Turbeville, Christopher Dean Kline and David William Locy Action

FINRA Hearing Panel Fines Brookstone Securities \$1 Million for Fraudulent Sales of CMOs to Elderly

Full Restitution of Over \$1.6 Million Ordered to Customers; Firm's CEO and Broker Barred; Former Compliance Officer Barred as Principal

WASHINGTON — The Financial Industry Regulatory Authority (FINRA) announced today that a FINRA hearing panel ruled that Brookstone Securities of Lakeland, FL, and the firm's Owner/CEO Antony Turbeville and one of the firm's brokers, Christopher Kline, made fraudulent sales of collateralized mortgage obligations (CMOs) to unsophisticated, elderly and retired investors. The panel fined Brookstone \$1 million and ordered it to pay restitution of more than \$1.6 million to customers, with \$440,600 of that amount imposed jointly and severally with Turbeville, and the remaining \$1,179,500 imposed jointly and severally with Kline.

The panel also barred Turbeville and Kline from the securities industry, and barred Brookstone's former Chief Compliance Officer David Locy from acting in any supervisory or principal capacity, suspended him in all capacities for two years and fined him \$25,000. The ruling resolves charges brought by FINRA in December 2009.

The panel found that from July 2005 through July 2007, Turbeville and Kline intentionally made fraudulent misrepresentations and omissions to elderly and unsophisticated customers regarding the risks associated with investing in CMOs. All of the affected customers were retired investors looking for safer alternatives to equity investments. According to the decision, Turbeville and Kline "preyed on their elderly customers' greatest fears," such as losing their assets to nursing homes and becoming destitute during their retirement and old age, in order to induce them to purchase unsuitable CMOs. By 2005, interest rates were increasing, and the negative effect on CMOs was evident to Turbeville and Kline, yet they did not explain the changing conditions to their customers. Instead, they led customers to believe that the CMOs were "government-guaranteed bonds" that preserved capital and generated 10 percent to 15 percent returns. During the two-year period, Brookstone made \$492,500 in commissions on CMO bond transactions from seven customers named in the December 2009 complaint, while those same customers lost \$1,620,100.

Two of Kline's customers were elderly widows with very limited investment knowledge, who, vulnerable after their husbands' deaths, were convinced to invest their retirement savings in risky CMOs. Kline told the widows that they could not lose money in CMOs because they were government-guaranteed bonds, and Kline further increased their risk by trading on margin.

Also, the panel noted that Locy completely ignored his responsibility as chief compliance officer and "should have been a line of defense against Turbeville's and Kline's egregious conduct," but instead "he looked the other way while Turbeville and Kline traded CMO accounts that were unsuitable for their customers."

The hearing panel concluded that Brookstone was responsible for Turbeville's and Kline's action. According to the decision, "the firm neither acknowledged nor accepted responsibility for the misconduct at issue in this matter. Instead, through Turbeville and Kline, it attempted to blame the customers for their own losses."

Unless the hearing panel's decision is appealed to FINRA's National Adjudicatory Council (NAC) or is called for review by the NAC, the hearing panel's decision becomes final after 45 days.

has been appealed proof attached

Investors can obtain more information about, and the disciplinary record of, any FINRA-registered broker or brokerage firm by using FINRA's BrokerCheck. FINRA makes BrokerCheck available at no charge. In 2011, members of the public used this service to conduct 14.2 million reviews of broker or firm records. Investors can access BrokerCheck at www.finra.org/brokercheck or by calling (800) 289-9999. Investors may find copies of this disciplinary action as well as other disciplinary documents in FINRA's Disciplinary Actions Online database.

FINRA, the Financial Industry Regulatory Authority, is the largest independent regulator for all securities firms doing business in the United States. FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA touches virtually every aspect of the securities business – from registering and educating all industry participants to examining securities firms, writing rules, enforcing those rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering the largest dispute resolution forum for investors and firms. For more information, please visit www.finra.org.

©2013 FINRA. All rights reserved. FINRA is a registered trademark of the Financial Industry Regulatory Authority, Inc.

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

-----X
Department of Enforcement,

Complainant,

v.

Brookstone Securities
(CRD No. 13366),

Anthony Lee Turbeville
(CRD No. 1721014),

Christopher Dean Kline
(CRD No. 2597293) and,

David William Locy
(CRD No. 4682865)

**Disciplinary Proceeding
No. 20070011413501**

Respondents.

-----X

RESPONDENTS' POST-HEARING BRIEF

TABLE OF CONTENTS

I.	Introduction.....	1
II.	The Managed CMO Portfolio Strategies.....	1-9
	A. The “Reasonable Grounds” Standard.....	5-6
	B. Prior Averse Performance in the CMO Market Did Not Make the Recommendations Unsuitable... ..	6-7
	C. CMOs Are Suitable Investment for Retail Customers.....	7-8
	D. Notice to Members 93-73 Was Authorized at a Time When the CMO Market Was Smaller, Less Liquid, and Far Less Diverse.....	8-9
III.	Selection and Approval of Suitable CMO Bonds for the Managed Portfolio.....	9-12
IV.	Assessment of Suitability and the Disclosure of the Material Characteristics and Risks of CMOs.....	12-20
	A. Tony Turbeville’s Standard Process: Assessing Suitability and Disclosure.....	12-15
	B. Chris Kline’s Standard Process: Assessing Suitability and Disclosure.....	16-17
	C. Age and Intellectual Capacity.....	17-19
	D. The Customers Were Not Mislead Concerning Par And Market Value.....	19
	E. The Customers Were Not Mislead Concerning the Alleged Margin Calls... ..	19-20
V.	Mr. Loc Adequately Supervised the Customers’ Managed CMO Portfolio Accounts.....	20-23
VI.	The Testimony Elicited by FINRA from the Customers and Customer Representatives is Not Reliable.....	23-25
VII.	The Managed CMO Portfolios Were Suitable for the Customers	

Identified in the Complaint.....	25-33
A. B█████ B█████.....	25-26
B. B█████ C█████.....	26-27
C. M█████ and M█████ R█████.....	27-28
D. S█████ B█████.....	28-29
E. I█████ D█████.....	29-30
F. C█████ P█████.....	30-31
G. J█████ G█████.....	32
H. H█████ P█████.....	32-33
VIII. Respondents' Information Sharing Arrangement with D█████ G█████ and B█████ U█████	
Did Not Violate Federal Securities Laws.....	33-35
IX. Damages.....	35-39
A. The Appropriate Method for Calculating Damages.....	35-39
B. Respondents' Were Denied Access to Data Necessary to Calculate	
"Out-of-Pocket Losses".....	37-38
C. Enforcement's Loss Calculations are Inaccurate.....	38
D. Even Respondents' Customer Gain/Loss Calculations are Incomplete	
Due to Insufficient Data.....	38-39
E. "Restitution" Is Not Permitted for Customers Who Have Settled	
Their Claims.....	39
X. Conclusion.....	40
Endnotes (<i>continued</i>).....	40-50

TABLE OF AUTHORITIES

Cases

<u>Affiliated Ute Citizens v. United States</u> , 406 U.S. 128, 155 (1972).....	38
<u>Blackie v. Barrack</u> , 524 F.2d 891, 909 (9th Cir. 1975), denied, 429 U.S. 816 (1976)	cert. 38
<u>Braemer Isle Condominium Ass'n, Inc. v. Boca Hi, Inc.</u> , 2d 707 (Fla. 4th DCA 1994)	632 So. 40
<u>Chandler v. Andrews</u> , 192 F. 543 (2d Cir. 1911)	38
<u>Dep't of Enforcement v. Medeck</u> , Complaint No. E9B2003033701, FINRA Discip. LEXIS 7 (FINRA NAC July 30, 2009)	2009 6
<u>Dunmire v. Morgan Stanley DW, Inc.</u> , 475 F.3d 956	36
<u>Elkind v. Liggett & Myers, Inc.</u> , 635 F.2d 156, 168 (2d Cir.1980).....	38
<u>Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.</u> , 527, 533 (10th Cir. 1962).....	303 F.2d 37, 38
<u>Eugene Erdos</u> , 47 S.E.C. 985, 988 n. 10 (1983)	6
<u>Hardage Enters., Inc. v. Fidesys Corp., N.V.</u> , 570 So. 2d 436 (Fla. 5th DCA 1990).....	40
<u>In re Warner Communications Securities Litigation</u> , 618F.Supp. 735, 744 (S.D.N.Y.1985), <u>aff'd</u> , 798 F.2d 35 (2d Cir.1986))	38
<u>Janigan v. Taylor</u> , 344 F.2d 781, 786 (1st Cir. 1965).....	38
<u>Kronfeld v. Advest, Inc.</u> , 675 F. Supp. 1449, 1455 (S.D.N.Y. 1987)	37
<u>Larry Ira Klein</u> , 52 S.E.C. 1030, 1037 n.29 (1996)	6
<u>Lawton v. Nyman</u> , 327 F.3d 30, 42-43 (1st Cir. 2003)	38
<u>Madigan, Inc. v. Goodman</u> , 498 F.2d 233, 239 (7th Cir. 1974)	38
<u>Michael Frederick Siegel</u> , Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, 2008), <u>aff'd</u> in relevant part, 592 F.3d 147 (D.C. Cir. 2010).....	(Oct. 6, 6
<u>Randall v. Loftsgaarden</u> , 478 U.S. 647, 661-62 (1986).....	37
<u>Sigafus v. Porter</u> , 179 U.S. 116, 45 L. Ed. 113, 21 S. Ct. 34 (1900).....	37, 38

<u>Smith v. Bolles</u> , 132 U.S. 125, 10 S. Ct. 39, 33 L. Ed. 279.....	37
---	----

Statutes

17 CFR §248.1(b).....	34
17 CFR §248.3(t)(1)(i).....	35
17 CFR §248.7(a)(1).....	35
17 CFR 248.10(a)(1).....	35
17 CFR 248.14(a)	35
17 CFR 248.14(b)(2)(i).....	35

I. Introduction

We believe that the evidence demonstrates that Chris Kline and Tony Turbeville had a comprehensive understanding of CMOs, that they had a reasonable basis for their recommendation of the managed portfolio strategies, that Respondents adequately disclosed the characteristics and risks associated with CMOs, that Respondents deliberately and methodically assessed their clients' suitability and adequately disclosed the material characteristics and risks associated with CMOs and that the strategies were, in fact, suitable for the clients identified in the Complaint.

We also believe that the evidence establishes that the Respondents engaged in a rigorous selection and compliance approval process for each of the CMOs utilized in the managed portfolios, and that the portfolios were subject ongoing review and supervision.

In the unlikely event that the Panel determines that restitution is justified, FINRA's damages calculations do not comply with the established legal standard and accurate damages are not ascertainable because FINRA failed to put into evidence the data required to perform a damages analysis in accordance with the legal standard.

II. The Managed CMO Portfolio Strategies

When the CMO Portfolio Strategy was commenced, the goal was to provide an above average return from the interest generated on the coupons and when applicable, the original issue discount. Hearing Transcript 2401:16-2402:13¹. There were few, if any other vehicles that could be utilized in the 2001-2004 timeframe that would create the income that the customers desired without an unsuitable level of risk. The uncertainty of the world after 9/11, low interest rates, the unattractiveness of owning and managing rental properties for most clients, low bank and insurance company yields, and a volatile stock market, left few alternatives for these customers. 1856:14-24, 2640:8-18, CX315

¹ Since the hearing occurred over the course of three weeks, hearing dates are not included. Hereinafter, citations to the hearing transcript will only reference the page and line numbers.

and CX338. Inverse Floaters² with high interest rates, often in excess of 10 percent were readily available, as were a variety of levers on the interest rates, prepayment speeds, and convexities. 1930; 1722:6-1723:12; 2100:10-2101:23; 2397:4-2398:5; 2604:5-12; 2797; 2623:20-2624:11.³ In light of the then-current coupon returns, Chris and Tony did not want the bonds to pay back the principal too rapidly instead they managed the portfolios so that the customers could collect more principal and interest payments from their investment. 2999:13-3004:11.

Reasonable interest rate moves were expected and were viewed as manageable. To that end, Interest Only⁴ CMO bonds ("IOs") were included in the portfolios to act as a partial hedge against reasonable rising interest rates. These IOs would reduce the negative impact on a portfolio experiencing normal rising interest rates. Id. All the while, the reps continued to analyze their individual client portfolios and the performance of the individual CMO positions in each of those portfolios. Id. As rates began to move upward, the coupons on the Inverse Floaters were affected. 1774:24-1775:14; 1776:4-12. Tony and Chris altered their overall strategies in response to the rising interest rate environment and adjusted the portfolio balances so that principal would come back more rapidly. By selling current bonds with lowering or no coupon and replacing them with newer current collateral bonds, it was possible to keep a greater income.⁵ 1876:18-1877:7; 1992:22-1993:20;

² If short term rates rise, then Inverse Floaters go down in both coupon and value. Rising long term rates also negatively affects value on Inverse Floaters. In other words, they move opposite to both long and short term interest rates. 1980; 1722-1723; 1726:23-1728 (re risks associated with IFs - credit risk, market risk, liquidity risk, interest rate risk). The strategies used, for the most part, Inverse Floaters. However, Chris also used tiered index bonds, a special type of Inverse Floater.

³ Tony has testified that returns of 10% in a CMO portfolio were extremely realistic in 1999-2000. 1930. It was very common to have bonds with coupons well into the teens and some in the 20s. 10% on a non-margin account was very realistic at that time and 15% in a margin account was also very realistic. 1883-1884; 1932-1933. Tony testified that he never guaranteed anything. He merely stated what was available when bonds were paying very high coupons. 2029.

⁴ IO's conversely moved the same direction as interest rates. 1980.

⁵ The representatives communicated their assessments and recommendations to the clients. Chris and Tony kept their clients informed concerning the status of their CMO portfolios and their evolving strategies and recommendations through regular verbal and written communication. While there are only a few examples of the Respondents' correspondence in the record, they are an indication of the Respondents efforts to inform their clients. In January 2004, Chris advised his CMO portfolio clients that he would most likely be implementing some new strategies in their accounts. CX317. In August 2004 both Tony and Chris sent their CMO clients a letter advising the clients that the rising interest rates environments had negatively impacted the value of their bond holdings. CX315; CX338. However, compared to the available alternatives, they still believed that the CMO portfolio was the best strategy. "The stock market is struggling, savings and CD rates remain low, real estate is in a bubble and the price of bonds have been negatively impacted by the expectation of rising

CX340; CX16. This strategy is known as rolling up the yield curve. It was important to keep the coupon and, by buying more front end support Inverse Floaters (as opposed to the later supports in the sequence), principal payments would come back faster and keep the average life shorter, rather than extending the life of the portfolio to an unacceptable level. 1721:7-14; 2121:21-2122:3; 2123:17-2124:4; 2139:14-2140:11; 2402:14-2403:7. They did this because it was unclear how long the fed might continue to raise interest rates. 2999:13-3004:11. Interest rates continued to rise with the yield curve starting to flatten in 2005 and by roughly July 2006 the curve inverted. The inversion continued until about May 2007 and went in and out of inversion until August 2007. 2706:3-2708:3.

During this time period, Chris and Tony abandoned Interest Only bonds because they were no longer effective as a hedge. 2999:13-3004:11.⁶ Tony and Chris considered alternatives for their clients but determined that there really was no other attractive investment strategy that could achieve their

interest rates.” The comments concerning the real estate market were eerily prescient. The letter states that while there is no “sure fire” answer as to what is the best course, there are several of the reasons that they believed that the clients should continue with the CMO strategy, namely: 1) although the valued can and do fluctuate, the US Government and Government Agency bonds pay back at par (price of 100). In other words, regardless of market valuations an investor will eventually receive 100% of principal for any bond that was bought at par or less. 2) while the investor is waiting for the bond to mature he or she receives the interest the bond is scheduled to pay, which is a nice source of income. 3) When using US Government or Government agency backed bonds the bonds have an implied rating of AAA.” CX315; CX338. In December of 2004, Tony and Chris sent another letter to their clients advising them about the continued volatility in the bond markets and the negative impact on the market value of the clients’ portfolios. The letters counseled their clients to remain patient and invited the clients to contact the rep if they had any questions whatsoever. CX339; CX318. Another letter was sent out in November of 2005 again discussing the continued bond market volatility and the negative impact on the value of the clients’ bond portfolios. Par value statements were provided while cautioning the clients that they should not disregard the monthly account statement data. This letter again provided Chris’ assessment of the current market conditions and his assessment that the Fed would likely begin reducing interest rates after another few increases. CX320. This sentiment was echoed in Tony’s correspondence to his clients in December 2005. CX 344; CX345. In April of 2006, Tony’s correspondence to his clients explains the strategy that he had employed to address the impact of increased interest rates on the customers’ portfolios, asks the clients to consider the issues related to par value in assessing the status of their portfolios and urges the clients to be patient while the interest rate increase cycle concludes and they enter into a more favorable lowered interest rate cycle. CX340. Much of this advice is reiterated in his correspondence sent in May of 2006. CX16.

⁶ The basic weakness in using IO’s as a hedge to Inverse Floaters is that the hedge requires a parallel shift in the short end of the interest rate curve (i.e. fed funds or one month libor) and the long end of the interest rate curve (ten year treasury note). If the short end moves faster than the long end, then the hedge will not work correctly or at all. Therefore, as short rates began to move and long rates did not, there was no reason to load up on a security that had no principal repayment guarantee and no helpful price appreciation and there was no trend suggesting there would be such appreciation in the future. 1775:15-1776:2; 1801:13-21; 1774:8-18; 2007:19-2008:9.

clients' investment objectives without excessive risk exposure.⁷ CX315, CX338. Instead, as interest rate increases ceased, Chris and Tony continued to modify the strategy to include Inverse Floaters that had already been deeply discounted below par since those type bonds would respond very favorably to interest rate decreases.⁸ 3001.

The Fed historically responds to an inverted yield curve signaling recession by lowering interest rates and Chris and Tony reasonably and, ultimately, correctly expected that The Fed would respond similarly to this advent of the inverted yield curve.⁹

Contrary to Enforcement's arguments, the evidence shows that the Respondents' active management of the accounts during the relevant time period was reasonable and appropriate. Mr. MacLavery testified that "their response to market conditions was very much in keeping with a proactive management style." 3140:3-14. He further stated "And I'm able to say it was active the right way given that the way they were rolling out of one coupon of collateral was going the right way. It was in keeping with what, not only an active manager would do, but an active manager that knew what they were doing would do." 3231: 4-10.

A. The "Reasonable Grounds" Standard

⁷ Mr. Kline's strategy included a heavier concentration of tiered index bonds because the coupon stays even in a rising rate environment to a point, and then starts declining. He wanted at greater stability of income because he had clients that pulled income on a regular basis. 2106:20-2107:5; 1725:21-1726:22; 2107-2108; 2317:10-16.

⁸ Another way to describe the change in the portfolio strategy would be to say that they were expanding or broadening the duration of the portfolios. Mr. Fong erroneously testified that there was no evidence that the Respondents considered duration 281:13-19. This is inaccurate. The Respondents reviewed the duration data that was available through the Bloomberg screens for each bond during their pre-purchase analysis as evidenced in each of the bond packets in evidence. 2113 referencing CX280:6; 2114:18-23 referencing CX 280:9. Additionally, while Tony did not perform an academic analysis of bond portfolio's duration, he frequently reviewed the bond portfolios, including their effective interest rates and average weighted life in order to assess how he should modify the portfolio to enhance their performance. 2522:8-16. Tony and Chris were aware that each bond in a portfolio would affect duration. As Chris testified, they understood that the durations were extended in the portfolio during the exam period. "We purposefully increased durations of our client portfolios by buying deeply discounted Inverse Floaters and, in many cases, discounted tiered index bonds so that when the Fed changed course and when they ultimately entered into a rate cutting campaign, which they did, these bonds would pay off very rapidly, par values would be received back into the portfolio." 2912:3-9. The duration of these bonds would reasonably be expected to contract significantly in a market where interest rates are declining. 2999:13-3004:11. In fact, despite the extended duration of the portfolios during the July 2005-July 2007 time period, they paid off at par and those bonds that remain have expected lives that are exceedingly short with many having factors of .18, .2 or .3. 2910; 2912:3-10; 2005:15-2006:10.

⁹ Tony and Chris were trying to reasonably anticipate how the interest rate market was likely to change. This was not merely speculation but rather a demonstration of what prudent money managers should always be doing – positioning their customers' portfolio's to respond to reasonably anticipated economic changes. 2999:13-3004:11.

The fact that a security, any security, can go up or down in value is not the measure of suitability or lack thereof.¹⁰ NASD Rule 2310 provides that “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.” Thus, a broker “must have **reasonable grounds** to believe that the recommendation is suitable for the specific customer at issue,” an obligation that is referred to as “customer-specific suitability.” Dep’t of Enforcement v. Medeck, Complaint No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *31 (FINRA NAC July 30, 2009); Dane S. Faber, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *23 (Feb. 10, 2004).¹¹

The Reasonable Grounds standard is not to be measured against what we now know with the benefit of hindsight but rather is to be measured against what was known at the time. Just because the assumptions underlying the managed CMO portfolio’s proved to be partially inaccurate does not mean that the Respondents did not have a reasonable grounds for making the recommendations.

Did they know that interest rates were going to move and would likely move upward? Of course they did, but they were prepared to manage a certain level of movement up and down over an extended period of time. 2999:13-3000:6. What they were not expecting and, what many other financial professionals were not expecting, was such a concentrated move in such a short period of time. RX71 ¶98-99. When that occurred, the Respondents had to determine if there was another investment strategy, another product that was available at that time, and that would meet the client’s

¹⁰ Larry Ira Klein, 52 S.E.C. 1030, 1037 n.29 (1996); see also, Eugene Erdos, 47 S.E.C. at 988 n.10.

¹¹ Before making a customer-specific suitability determination, a registered representative “must first have an ‘adequate and reasonable basis’ for believing that the recommendation could be suitable for at least some customers,” an obligation that is often referred to as “reasonable basis suitability.” Michael Frederick Siegel, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *28 (Oct. 6, 2008), aff’d in relevant part, 592 F.3d 147 (D.C. Cir. 2010); Medeck, 2009 FINRA Discip. LEXIS 7, at *3 “The reasonableness of any recommendation is predicated on a registered representative’s understanding of the potential risks and rewards inherent in that recommendation.” Siegel, 2008 SEC LEXIS 2459, at *28 (internal quotation marks omitted). As demonstrated later in the brief, both Tony and Chris studied and obtained an extensive understanding of the CMO products before they recommended CMOs to their clients.

investment objectives and risk tolerance. That is exactly what they did. They surveyed the options, told their clients what the other options were and explained to their clients the reasons why they did not think that those other options were suitable. CX315, CX338. Many of the experts were saying that given the concentrated move up in interest rates in such a short period of time and the advent of an inverted yield curve (signaling recession) the next logical step for The Fed is to lower rates. RX71¶100; CX320. If you think that rates are going to be lowered, there is a reasonable basis for modifying the strategy to position the portfolios so that they will respond favorably to a reduction in interest rates.

B. Prior Adverse Performance in the CMO Market Did Not Make the Recommendations Unsuitable

FINRA has argued that interest rates had experienced similar significant moves higher in times past. Therefore, no sensible financial professional would have recommended the strategies pursued in the Managed CMO portfolios. While that is a very tempting argument to fall prey to, it is not a legitimate one. There have been stock market crashes in the past and yet no investment professional would seriously argue that a representative who recommended an equity portfolio to his client in 2007 lacked a reasonable grounds for doing so simply because the equity markets crashed in 2009.

Although there had previously been times where interest rates rose dramatically, not even (as noted by Dr. Sabry) in the 1979/1980 time period did the “long end of the [yield] curve decline early on when the Fed is trying to tighten it.” 3349:6-18. By comparison, what happened to the bond market during the 2005 to 2007 time period (rising short-term rates combined with flat and declining long-term rates) was unique. Academics and financial professionals uniformly regarded it as such. – even Fed Reserve Chairman Alan Greenspan famously called it “a conundrum”. RX 71¶ 101. Mr. MacLavery testified that the interest rate environment during the relevant time period was unprecedented. “[From mid-2005 to mid-2006] there was a brutal squeeze on rates and therefore tremendous pressure – downward pressure on fixed income products ... that was unprecedented and not foreseeable.” 3107:19-24. Dr. Sabry agreed: “As we were sitting in 2005, I believe that the evidence suggests that it’s not. It was not reasonably foreseeable that – it was not reasonable to foresee the changes that happened in the yield curve.” 3336:8-12.

If the academics and financial professionals are to be believed, the fact that the CMO market had negatively performed in 1994 did not make the 2005-2007 events and the impact on the inverse floater CMOs at issue "reasonably foreseeable." RX71:29-32.

A financial professional has to make an assessment of the economic environment that they are in at that time and plan their clients' strategies accordingly. Respondents contend that the Respondents, like many another and more renowned financial professional, assessed the interest rate environment and their assessment proved to be inaccurate. That in no way means that there was not a reasonable basis for their investment strategy.

C. CMOs Are Suitable Investments For Retail Customers

Tony was asked why he thought that customers with different asset valuations were suitable for investments in CMO's. 2219:8-16. We think this betrays a fundamental ignorance of the CMO portfolios. FINRA seems to not understand that CMOs, even ones that share the same classification such as Inverse Floaters, can be suitable for different investors with different risk profiles depending on the lever, weighted average life, collateral support and other factors. 2517:14-2518:25. The customers did not all possess the same portfolio and not every CMO customer would purchase the same bond. 2142; 2434:11-17. Conversely, investors with different investment objectives might still own some of the same CMO bond. An income investor could own a bond that was suitable for an "aggressive income" investor and an "aggressive income" investor could own a bond that was suitable for just an "income" investor. You might have a CMO that works well for the different portfolios of say, Mr. R and for Ms. B. 2131-2132; 2315:12-2316:13.

Mr. MacLavery testified that, in formulating his opinions¹² on suitability, he reviewed copies of the account opening documents¹³ for the customers at issue, looking at suitability factors like "risk profile, general level of sophistication, goals and objectives." 3083:24-3084:3. He testified unequivocally that the CMO "investment strategy was suitable given those investment objectives." 3082:23-25; 3083:2. Moreover, as Mr. MacLavery testified, suitability is assessed at the "front end." 3086:8. Thus, Mr. F's use of customer

¹² Mr. MacLavery's report states that he concluded that "The [CMO] investment strategy was suitable for the Brookstone Accounts based on their investment objectives." RX70:5.

¹³ In assessing customer suitability, Mr. MacLavery testified that "priority document that I look to, which is, I would say, typical of most advisors, is the account opening documents." 3084:25-3085:13.

declarations that were prepared by FINRA staff – which Mr. MacLavery noted were “after the fact statements” that “have the benefit of hindsight on what had gone on in the marketplace” – to opine on suitability is an entirely improper way to conduct a suitability analysis, and his testimony and report on this issue should, therefore, be disregarded. 3087:21-3088:6.

D. Notice To Members 93-73 Was Authored At a Time When the CMO Market Was Smaller, Less Liquid, and Far Less Diverse

The Notice to Member 93-73 (the “Notice”) was issued at a time when the CMO market was dramatically smaller, less liquid, less diverse and far less mature. Dr. Sabry and Mr. MacLavery each testified regarding the changes in the CMO market since the issuance of the Notice. As Dr. Sabry testified, more information has become publicly-available and easily accessible regarding agency and GSE-issued CMOs. 3322:21-3323:17. Mr. MacLavery testified in great detail about how the changes in the CMO market between 1993 and 2001 rendered the Notice “a dated document” that didn’t apply in the same way as it did in 1993/1994. 3246:7-21. The changes Mr. MacLavery noted in the CMO market included growth in liquidity, transparency, increased availability of data (such as prepayment), and technological advances which allowed end-users and broker-dealers to analyze CMOs. 3144-3148. The CMO market in 2001 (and the relevant time period of July 2005 to July 2007) was radically different from the market as it existed in 1993, when the Notice was written. Mr. MacLavery’s characterization of the Notice as being “dated” was therefore a generous understatement.¹⁴

Moreover, FINRA has not codified the position set forth in the Notice, has not issued further guidance addressing any concerns with the radically changed CMO market, and apparently has not treated sales of CMOs to moderate or conservative investors as violations of FINRA’s code. For example, in the Investors Capital matter¹⁵, while FINRA did not make an explicit finding of unsuitable sales¹⁶ to customers of Inverse Floater and IOs, FINRA determined the firm’s policies and procedures did not provide for an adequate suitability review,

¹⁴ Chris testified that he had complied with the rule by verifying that each and every one of his particular customers was well educated as to CMO and the risks associated with CMOs and that they had the appropriate investment objectives and risk tolerances. 2918:14-21. Tony disagrees with FINRA’s position as set forth in the Notice. It is his opinion that CMO’s may be suitable for some retirees depending on the risk tolerance, investment objectives, experience, net worth and what they are trying to accomplish. 2184; 2156-2157:22. Tony spent about an hour to an hour and a half explaining CMO’s to each customer that decided to invest in CMO’s. 2191. The CMO market was huge and very liquid. Clients were informed about the size of the market which was several hundreds of billions of dollars. 2638.

¹⁵ FINRA Letter of Waiver, Acceptance and Consent No. 2007011545201, dated August 22, 2011 (Investors Capital Corp., CRD No. 30613).

¹⁶ One wonders how it is possible that to find that the transactions were suitable if, as noted in the AWC, there was no basis for determining the sophistication of the customer or the customer’s risk profile.

including whether the purchasing customers were sophisticated or had a high risk profile. The AWC noted that some 40 customers were not subject to an adequate suitability review. FINRA did not take the opportunity to further define or clarify the suitability standards applicable to the purchase of CMOs by retail investors. Indeed, if the position expressed by Mr. Fong (that Inverse Floaters and Interest Only CMOs are “never” suitable for retail investors) was valid, why did FINRA not take the same position in the Investors Capital AWC? Or in the recently decided case, Dep’t of Enforcement v. David Lerner Associates, Inc., No. 20050007427 (O.H.O April 4, 2012)¹⁷?

The AWC also stated that “[t]he Firm’s written supervisory procedures were further deficient in that they did not require its registered representatives to offer customers the CMO educational materials required by NASD Rules. As a consequence, both during the Relevant Period and afterwards, Investors Capital failed to offer educational materials regarding CMOs to its retail customers as required by NASD Interpretive Memorandum 2210-8 and brokers involved in selling CMOs to retail customers were unaware of this requirement.” This statement stands in stark contrast to extensive, detailed, and accurate¹⁸ CMO disclosures that the Brookstone Respondents provided to their customers.

III. Selection And Approval Of Suitable CMO Bonds For The Managed Portfolios.

Tony and Chris have testified as to the very deliberative process involved in selecting the bonds that would be purchased in each customer’s portfolio. With regard to Tony’s testimony, Tony would look at individual customer’s investment objectives and review what they were trying to accomplish in particular portfolios. He would then call D [REDACTED] G [REDACTED] to discuss his proposed strategy and particular objectives. If they agreed that Tony’s logic made sense, Tony would instruct G [REDACTED] to find bonds that met Tony’s criteria. Tony, D [REDACTED] G [REDACTED] and often Dave Locy, would then review the prospective bonds, and pull them up on the Bloomberg screens, to ensure that they had the characteristics that Tony wanted in the bonds. 2139:24-2140:22; 2309:13-21; 2313:14-2314:19. Using the Bloomburys you could obtain all sorts of necessary information:

¹⁷ The hearing panel in DLA found that the firm had charged excessive mark-ups to retail investors on CMOs (more than 50% of which were “support bonds” like the IOs and Inverse Floaters in this case) and municipal bonds. No allegations relating to suitability were made, and the CMOs sold by DLA were (unlike the CMOs sold in this case), from private issuers (albeit with AAA ratings) rather than agencies of GSEs.

¹⁸ The hearing panel in DLA found that the firm had charged excessive mark-ups to retail investors on CMOs (more than 50% of which were “support bonds” like the IOs and Inverse Floaters in this case) and municipal bonds. No allegations relating to suitability were made, and the CMOs sold by DLA were (unlike the CMOs sold in this case), from private issuers (albeit with AAA ratings) rather than agencies of GSEs..

"[Y]ou could see what the WAC was, the weighted average life. You could see yield to maturity. You could stress test it to see if interest rates went, how far it is going to go down. And it goes down, how far is it going to go up. If you have the coupon, what is going to happen to the average life, you know, what is the duration risk, all of those things were available and more in Bloomberg. It is amazing what you can get through that." 1740:3-12.

Once the appropriate bonds had been located, Tony would then confer with Brookstone's K [REDACTED] H [REDACTED] and they would review each client. "[W]e would go through the clients and would look at their portfolios, their par values, using the par value reports, in this particular instance. Look at their investment objectives, the risk tolerances and whether they were to pull an income, not pull an income" -- 2141:3-9. While the final spreadsheets grouped clients that had similar investment objectives together, this does not mean that bonds were simply placed into customer accounts based solely upon their investment objectives and risk tolerances. Tony would then select which accounts' portfolios should receive the particular bond. "[Y]ou have to look at their individual portfolio's and say, you know, does this bond make sense with the other bonds that they currently owned based on what we are trying to accomplish, be it income or rebuilding par value or both." 2142:21-2143:2. Not every customer would participate in every block purchased. 2142:8-11; 2315:12-2316:13; 2338:2-2340:19. Mr. Kline's bond selection process was quite similar:

If I could back up, the process in general that we would use in terms of constructing our portfolios would be each month I would sit down with all of my clients' data. I would go through each one of my clients' portfolios, typically after the end of the month when statements had come out. I would review them and identify how much principal and interest was available for new investment. I would construct a spreadsheet on my end and essentially, if we were to look at a spreadsheet, it would have all the bonds that all of our – my clients owned along the top and all the individual account numbers along the side. And then I would populate that spreadsheet with all the particular CMOs that we had owned. And it, at a glance, provided me the opportunity to see the constructions of the portfolios very quickly and very clearly. At that point I would identify and recognize whether or not one or more CMOs with any one particular client that I held and managed the money for needed to be adjusted. In other words, a CMO may need to be sold or another CMO that I might want to be bought. Once I identified certain parameters that I wanted for a particular construction of a portfolio, I would contact Mr. Turbeville and we would have a conversation as to whether or not that same portfolio construction and that same parameter of one or more CMOs that I might want could fit within any of his client accounts. We would come to an agreement on one or more parameters that we were looking for. We would then contact Mr. Green¹⁹, give him those parameters, and say, will you please go and identify for us one or more CMOs

¹⁹ It was shortly after the loss of the Pasco account that Chris sent a poorly worded email to Mr. G [REDACTED] and Mr. U [REDACTED] (CX270) which could be misread to imply that U [REDACTED] and G [REDACTED] were actually managing the investment decisions of the Kline customer accounts. However, Chris' testimony and that of the other Respondents is that Chris was clearly the person managing the investment decisions of his clients' managed CMO portfolios. Mr. G [REDACTED] and Mr. U [REDACTED] were managing the

that would fit these parameters so that we can identify them and place them for our clients' accounts. I might at that also time -- at that time -- present to Mr. G [REDACTED] one or more CMOs that I would be interested in selling to replace with a CMO that I might be asking him to give me parameters for the buy. He would give me an indication as to whether or not he felt that made sense based on his perception, his understanding of current economic environments, his understanding of the details of that CMO. I'm not too proud to think that I know everything. And so for me it was a very helpful process to have a professional -- more than one -- Mr. Turbeville in addition to Mr. G [REDACTED] -- communicate my thoughts, my ideas as it relates to the construction of my client accounts.

2894:9-2896:9. See also, 2309:12-21; 2313:14-2314:23; 2338:14-2340:19.

[O]nce we got to the point of identifying the exact CMO that we either wanted to buy or sell, I would create a blotter on my end that reflected the particulars as it relates to the amount of money to be invested for each particular account and I would send that to Mr. Locy who would then go over and review that particular trade blotter with K [REDACTED] H [REDACTED] who, at that point, would communicate with Mr. G [REDACTED] office and from that point make the trades take place.

2899:20-2900:5.

The firm memorialized the bond selection, suitability review and compliance review process by collecting the relevant data evidencing its review and approval process into a "Bond Package". (RX121, RX 123-134, RX 137-139, RX 142-147); (See also CX 280-283; 2472:2-18; 2484:13-2485:6). There was no requirement that the firm create this record but the firm did so to evidence the Firm's due diligence, compliance and suitability review. 2092; 2314:24-2315:7. A typical Bond Package would include a cover page explaining the logic for the purchase (2093:12-2094:8), and Bloomberg printouts containing the description and technical analysis of the bond. These Bloomburys would include information concerning stated maturity, factor, average weighted maturity, floater formula, prepayment speeds, FFIEC shock test, high risk security test, and option adjusted spread analysis. See generally 2093-2121. Dave Locy would usually indicate his approval on the cover page. 2094:6-7.²⁰

administrative functions of the portfolios. The proper context of the use of the word "management" is key to understanding the intent of the email. 2893:3-2894:2. Mr. Kline's extensive knowledge of the products as demonstrated through his testimony and the correspondence with his clients (e.g. Mr. Kline's correspondence to Ms. Borek (CX 273: 9-11)) make clear that the strategy and the clients' portfolios were managed by Mr. Kline. 2621-2644. Furthermore, Dave Locy has testified that based upon his knowledge of the bond selection process it was Chris and Tony, not U [REDACTED] and G [REDACTED] that made the decisions as to CMO bond transactions in the accounts. 2370:19-2372:11. Mr. Locy even chided Chris for trying to foist blame on U [REDACTED] and G [REDACTED] when Chris was clearly the one that actually managed the investment decisions in the accounts. 2372:16-2374:15.

²⁰ Curiously, the bond packages offered into evidence by FINRA were missing certain critical documents that were always included in each Bond Package, including the blotters and trade tickets. 2590:8-2591:18. The absence of these documents from the Bond Package, in Respondent's view, makes the compliance and suitability review appear less thorough than it was. The bond packages entered into evidence by Respondents show the Bond Package as it was actually maintained in Brookstone's records. RX21;123-134;137-139;142-147. It is unclear why FINRA's Bond Package exhibits are incomplete but we do note that FINRA has asserted in response to Respondents' discovery motion, that the haphazard and disorganized

IV. Assessment of Suitability And The Disclosure Of The Material Characteristics And Risks Of CMOs.

A. Tony Turbeville's Standard Process: Assessing Suitability and Disclosure

Tony Turbeville has been in the securities industry since 1987. He was qualified as a Certified Financial Planner. He possesses several securities licenses, insurance licenses and he co-founded and served as the chairman of Community Southern Bank founded in 2006 until June 2011. Tony testified that he researched and studied CMO's extensively before offering the products to any of his clients and he has demonstrated a comprehensive knowledge of the CMO product. 2092-2104. Hearing Officer Hall has acknowledged Mr. Turbeville's thorough knowledge of CMOs. 2104.

Tony was very clear as to the standard business practice that he followed to determine his client's suitability and to educate them as to the materials risks and characteristics of CMOs.²¹

Each of Tony's three customers identified in the Compliant was either referred to Tony by another customer or met Tony through one of his general seminars. See 1760-1761. It is important to note that Tony was NOT cold-calling these CMO customers. Tony was not recommending CMO portfolios to these three customers after a 15 minute phone conversation. The process was far more thorough and deliberative than that. As Tony testified, he would normally have several meetings with a customer before that customer would open an account. 1759. The first meeting would be to gather the pertinent information concerning the customer. 1762-1763. Tony would speak to them about the importance of certain legal documents, long term care insurance, life insurance, annuities, a listing of their assets, income and net worth. 1758-1759; 1764. Tony would then digest that basic information and after a week or two or longer, Tony would have a second meeting with the customer to discuss a preliminary plan with the prospective customer. 1759-1760. That was not a plan set in stone, it was meant to be a baseline for further discussion as to the various suitable investment options that were available to that customer. 1759; 1762. If the customer wanted to proceed, Tony would get into more detailed explanations of the various investment options. 1763. In the instances when a CMO portfolio was discussed as a suitable

production of discovery to the Respondents reflected the actual disorganization of FINRA's investigative file. i.e. FINRA's file was a mess so they produced the same disorganized mess to Respondents.

²¹ "Once you have the presentation the presentation it is pretty darn consistent client to client, the way you fill out the paperwork is pretty consistent, the way your staff handles the process is pretty consistent". 1792:12-16. "We get them all the same way all of the time". 1792:19.

investment option, and the customer was interested in pursuing that option, Tony would give a detailed and lengthy verbal presentation of the characteristics and risks of CMOs and would use the white board in his office to draw diagrams that would assist with those explanations. 1763. The presentation would last approximately 90 minutes. 2191. He would also provide the customers with a pamphlet that reiterated his verbal white board presentation.²² 1969.

If the customer understood the investments and indicated that he/she wanted to proceed, then Tony's assistants would prepare the opening account paperwork. 1763: 21-25. The paperwork would be prepared based on all the information that Tony had had gathered up to that point. Once the paperwork was filled out²³, the customers would be invited back to review and execute the paperwork and finalize certain information, such as investment objectives and risk tolerance. 1764; 1768.²⁴ Although the customer did not finalize his/her selection of the investment objective or risk tolerance until the "paperwork" meeting, risk tolerances and investment objectives would have been discussed in advance preliminary to the discussion of various investment options. The paperwork review provided an additional opportunity to review the client's objectives and risk tolerances with them. 2193:6-2194:23.

The paperwork review was not just some cursory review. Tony would start with a review of the account application, which included the customer's financial profile, risk tolerance and investment objectives. Tony would review each listed investment objective with each customer. He would read the definition for each investment objective and then expound upon each definition so that his client could make an informed decision. 1791:24-1794:1. The clearing firm, First Southwest, would send a summary of the account application profile

²² The contents of the brochure are independent proof of the type of information and the explanations that Tony was presenting to his clients as far back as 2002. To highlight a few of the items, Page 6 of the pamphlet describes the perfect hedge; Page 9 explains how hedges work in a scenario that would occur if interest rates fall; Page 14 explains the process of buying and selling a bond and compares it to a real estate transaction. Tony used this analogy not because it's a perfect analogy but because virtually everybody is familiar with the purchase and sale of real estate. 1975-1976.; Page 18 describes an inverted yield curve. 1978.; and Page 19 discusses some of the items that the customer should consider before investing in securities. 1978-1981.

²³ FINRA tries to imply that filling out the paperwork for the customer is improper. This position is a bit ridiculous since FINRA itself prepared customer statements for the customers' signatures. That aside, both Tony and Dave Locy testified that it is a standard industry practice to fill out the paperwork for clients based upon the information they have provided to ensure the completeness of the paperwork. 2295-2296.

²⁴ When Tony was transferring to a new firm he would typically have his staff fill out the new account forms and forward the new paperwork to the customers with the instruction that it was based on their old paperwork and that they should review it and sign it if there were no changes to be made. 1769; see also, 1945-1946.

directly to the customer each year.²⁵ 1795:1-24; 2288:7-2289:2. Tony would also take the opportunity to review the material risks and characteristics with the customer including a review of the "Disclosure for Collateralized Mortgage Obligation Securities". This is the document that included the disclosures that the NASD required at the time. 1807:15-18. It includes disclosures relating to the impact of CMO sales prior to final principal prepayment, principal guarantee limitations, impact of prepayment rates, impact of rising rates on Inverse Floaters, yield and average life assumptions, prepayment assumptions; the fact that the strategy primarily called for the purchase of Inverse Floating Rates and IOs; and, the fact that the customer acknowledged the receipt of the "Investor's Guide to Collateralized Mortgage Obligations" booklet.²⁶ RX1:5.

Tony testified that with this form, and any other form requiring signatures, he would read each disclosure to the client while the client was also reading the document. He would expound on the explanation and refer to information that was previously related to the customer during his prior white board presentation. He would then ask them if they understood the disclosure. If so, he would ask them to initial next to the particular disclosure and then move on to the next disclosure. Finally, he would have the customer sign at the bottom of the form. 1808-1809.

Tony would also review the "Account Owner's Statement of Understanding" with each customer. This was a form that was created by Brookstone to provide even more information to the customers than what was required by the NASD. The Respondents felt that these disclosures were necessary to inform their clients of various liquidity risks. 1799:13-21. For example, these disclosures included warnings concerning losses that would be incurred if the client decided to liquidate the portfolio during a steep inverted yield curve. RX1:4.²⁷

²⁵ We should note that the opening account form was created by the clearing firm. The clearing firm requires that each of the investment objectives must be ranked 1 through 5. So for instance, even if the client had no interest in "speculation", the customer would still have to assign "speculation" a ranking, presumably the lowest ranking, a "5". 1953; see also 2490:18-2491:9.

²⁶ Obviously, the disclosures are lengthier than what is summarized in this list. We invite the panel to review the disclosures at RX1:5.

²⁷ The disclosure also asked the customer to agree not to transfer out the positions, but rather to allow the positions to be liquidated at Brookstone. This was done because Brookstone was concerned that if the positions were transferred they may be liquidated by someone who did not have sufficient knowledge or expertise with these products. 1800. The panel may recall the problems that Ms. C encountered when she transferred her positions to Raymond James. 1892. Ms. C owned CMO securities at minimum denominations and they would not transfer to Raymond James. They came back as non deliverable. When that occurred, Ms. C signed a statement acknowledging that it was a very bad time for positions to be liquidated. Brookstone then liquidated the positions and the cash was transferred. This disclosure was meant to anticipate and avoid those type of problems. See also, 1827-1828.

As with the other forms, Tony would read each disclosure to the client while the client was also reading the document and confirm the client's understanding of each disclosure. 1808-1809.²⁸

Why was the paperwork process so deliberate and why were the customers asked to repeatedly initial and sign the paperwork? It is the best way to evidence what was discussed and what was agreed to with certainty after memories fail, time passes or other motives inspired customers or FINRA to dispute what occurred. It also happens to be the standard practice in the brokerage industry to get customers to acknowledge the information that they are provided. In fact, FINRA has repeatedly indicated that it believes that it is a "best practice" to have customers sign disclosures.²⁹ As Tony stated, it is difficult to understand how a rep can follow a deliberate practice of having each customer initial and sign the account forms and disclosures and still have FINRA accuse you of not providing the customers with the disclosures. 1810.³⁰

B. Chris Kline's Standard Process: Assessing Suitability and Disclosure

Chris has been in the securities industry since 1995. He was unable to complete his University studies because he was supporting himself and he lacked the funds to finish his studies. Instead he decided obtain his

²⁸ Tony was also careful to explain the final stated maturity date. Tony would explain that while some of the bonds had final maturity dates that were very far out, it would be very likely that a large portion of the underlying mortgages in that bond would pay off well in advance of the final stated maturity date. When explaining the concept of duration to his clients, Tony would say to them, "In your opinion do people keep mortgages for 30 years?" They would all kind of chuckle and say "no" I've never kept one for 30 years." 1889-1890; 2184. Tony testified that the bonds had an average weighted live of less than seven years. 2486.

²⁹ FINRA Regulation Guidance No. P038849 - Portfolio Margin FAQs. Also, in FINRA's guidance to customers, FINRA advises customers that they should not sign account forms "unless you thoroughly understand and agree with the terms and conditions they impose on you." FINRA understands that signing documentation is a clear indication that a customer understood and accepted the terms set forth in the document. FINRA Getting Started, Smart Investing - Opening a Brokerage Account

³⁰ There is ample corroborating evidence with respect to Tony's Standard Processes. First, a claimant in an arbitration proceeding produced documents as part of his discovery production that were provided to him when he opened his account with Tony. The discovery production included a White Paper that was prepared by Tony for his customers as a detailed explanation of CMOs. RX115. This White Paper was submitted to the NASD for approval when Tony was at Archer Alexander and Kovack Securities and it was approved. 1967-1968; 2307:15-22. Tony testified that this White Paper was essentially his verbal white board presentation in written form and it includes all the concepts he covered in detail on his white board. Tony would give each customer the White Paper as a reminder of the presentation so that they customer could review all of the information on their own time. 1969. It is also very significant that a customer/claimant in an arbitration proceeding, Mr. E. produced this paper. It is independent proof from an individual customer that is not involved in these proceedings that Tony was actually providing this CMO White Paper to his customers. The contents of the brochure are independent proof of the type of information and the explanations that Tony was presenting to his clients as far back as 2002. Second, there was Ms. R. testimony confirming, at least in part, Tony's testimony concerning his recitation. You will call that she testified about remembering the fulcrum diagram as part of Tony presentation. 658. Third, you may recall Ms. C. testimony in which she acknowledged that Tony explained the product to her and that she understood the explanations at the time that they were offered. 69:8-10; 133:6-14. Dave Locy also testified that he specifically recalls walking by the glass walled conference room and could tell if Tony was with a CMO customer if he could see the various CMO diagrams on the white board. 2282:9-2283:3; 2564.

insurance licenses and, eventually joined the securities industry. He is a Certified Financial Planner and possesses a series 7, 63 and 65 licenses.

Chris Kline studied the various CMO products extensively before he began offering the products to his clients. His hearing testimony demonstrates his comprehensive knowledge of the products. 2621-2644.

None of the 5 customers identified in the Complaint were cold-called by Chris. In fact, most of Chris' prospective clients were referred to Chris by an insurance group for whom he previously worked. Typically, Chris would schedule two hours for an initial client meeting. During the first meeting, Chris would gather information concerning the prospective client's life and investment experience, income, investment objectives. Based upon the information provided, Chris would then identify those types of investments that the prospective client might be interested in discussing (e.g. equities, annuities, CDs, CMOs). If the client might be suitable for an investment in a managed CMO portfolio, then Chris would start a discussion of CMO's by reviewing the CMO guide created by the Bond Market Association for a full discussion of CMOs and the risks associated with them. 2644:19-2648:21; 2686:14-24; RX72. Chris used a series of diagrams and other presentation methods, some of which he obtained from Tony, and presented them to the client as part of his explanation. For example, Chris testified about using a large oval diagram to illustrate the two most common CMOs, floaters and Inverse Floaters, and how cash flow for a particular pool of mortgages would flow based upon different interest rates from the floater side to the Inverse Floater side of the diagram and vice versa. Chris included in his demonstration a discussion of the impact of both declining and rising interest rates on the performance of the bonds. 2649-2652; RX72. Chris' presentation always included a discussion of inverted yield curves and the risks that they posed to the strategy. 2739:19-14; 2830:9-2831:23. Once Chris had completed his initial review of the products, he ended the meeting to allow the prospective client to consider the materials and formulate questions. 2653; 2819:4-10. Chris then waited several days before calling the client and, if they were still interested, schedule another meeting with them.³¹ 2654:21-2655:10.

³¹ The process for already existing customers that were transferring with Chris from a predecessor broker dealer was a bit different. Chris contacted the customers and let them know that he was going to be sending them some pre-filled new account paperwork based upon the paperwork that they had already completed. Chris instructed his clients to correct and update any of the information on the form if necessary. 2565. All of Chris' clients identified in the complaint had, at some point, been through his presentation and explanation concerning CMOs. 2656:25-2657:6. When transferring a CMO account to Brookstone, Chris would send the Customer Risk Assessment to his clients in blank because the predecessor firm did not have a similar document from which Chris' staff could pull information to pre-populate the form. 2659:7-14.

The new account forms were completed based upon information provided by the client and Chris reviewed the forms with each customer. For example, Chris reviewed with each customer the "Disclosure for Collateralized Mortgage Obligation Securities." 2672:63-2673:11. (This form is discussed at page 14.) Chris' practice was to review this form, and any other form requiring a customer's initials and signatures, by reading each disclosure item to the client. Chris asked the customer questions, and also referenced his prior discussions with the customer. 2672:23-2673:11. Chris testified that his practice also included a review of the "Account Owner's Statement of Understanding" with each customer. 2667:21-2668:2. This was a form created by Brookstone to provide even more information to clients than what was required by the NASD. (See page 15.) As with other forms, Chris read each disclosure to the client while the client was also reading the document and confirm the client's understanding of each disclosure. 2667:21-2668:2; 2729:6-7; 2825:6-2826:10.

C. Age and Intellectual Capacity

Both Chris and Tony testified that age and intellectual capacity were issues to be considered. Tony testified that he believed that the rep should always consider whether an older investor has the capacity to understand the investment and the risks, but stated that many older people are sharp enough to understand the risks and characteristics of CMOs. 1833-1834. While Inverse Floaters and IO's have some complexity in their structure the basic concepts are understandable to many investors. 2153:21-23. If, and only if, Tony was satisfied that the customer understood the underlying concepts and the risks present, would he be willing to make that investment for the customer. In Tony's view, if the customer did not evidence an understanding of the product and the risks, then that investment was not suitable. 1811:17-21. With regard to CMO investments, Tony wanted a customer with the intellectual capacity to understand the concepts underlying the investment, the willingness to be educated concerning CMO's, with a moderate to aggressive investment style, and income to aggressive income as an objective.³² He also wanted customers who would be willing to leave the strategy in place over time, particularly through an inverted yield curve. 2173. Tony assessed the customer's understanding by gauging their participation and by asking the customer questions. 2174.

The managed CMO portfolio might be a suitable investment vehicle even for older customers. While age was a concern, it would be less of a concern if the assets were intended to be legacy assets to pass on to

³² And, in rare cases, an investment objective of growth if they were not pulling income.

heirs, if the CMO portfolio was a small percentage of the investment assets, or if the customer had sufficient cash to satisfy their current expenses and liquidity needs. 2485:11-2486:9. A CMO portfolio might still meet the particular investment objectives of an older client that understands the risks (including liquidity risks). For example, while Ms. B's investment objective was income, she was not looking for an income stream to meet her living expenses. She wanted an investment that might generate sufficient revenue for her to satisfy her minimum IRA distribution. The CMO portfolio was a reasonable strategy to employ for that particular goal. 1838:5-1841:8.

As Chris testified, if at any point during the opening account process, the customer did not understand the product or the risks, Chris would explore other investment strategies with them. 2674; 2831:24-2832:14. Chris gauged their level of understanding by having them answer questions. 2673:12-19. Additionally, Chris called his clients every month after they had received their monthly account statements to discuss economic changes and interest rate changes, to ensure that they understood what was happening in their accounts, and to determine if they had any questions or concerns. The monthly call also gave Chris an opportunity to ascertain any changes in the clients' investment objectives. 2675:23-2676:11; 2740:5-21; 2791:21-25; 2740.

D. The Customers Were Not Mislead Concerning Par And Market Value

Mr. Brown testified that he believed the statements concerning par value set forth in various letters to the clients was misleading because the portfolios were not necessarily holding the bonds to maturity. 1194:16-1195:18.

The par value of a CMO bond, unlike other fixed income instruments, is a significant piece of data for CMO investors precisely because of the unique structure of CMO bonds -- CMO bonds repay a portion of their principal back on a monthly basis and that principal is paid back at par value. 2904:15-2905:25. Is it really significant for the client to know that they are getting a portion of par value back every month on a thirty year mortgage? Yes, because while the collateral for the bond might be thirty year mortgages, the vast majority of those underlying mortgages are going to be repaid long before thirty years. As interest rates decline, prepayment speeds increase, homeowners move, homeowners refinance and as payments accelerate the owners of the bonds receive larger monthly payments. 2906:7-22. While market value should not be ignored, market value does not measure the value of this particular aspect of CMO bonds. In fact, the Respondents never advised their clients

to ignore market value; they provided market price and par value data to their customers and discussed the significance of both with the clients so that the clients would be able to make informed decisions concerning their managed CMO portfolios. 2905:25-2906:6; 2882:18-2883:2-6; 2003:1-2004:21; 2908:21-2909:3. Respondents contend that Mr. Brown's opinion on the matter is uniformed and further demonstrates an ignorance of the portfolio strategy of rolling up the yield curve as discussed earlier.

E. The Customers Were Not Mislead Concerning The Alleged Margin Calls

FINRA has asserted that the margin calls in certain customer accounts were due to the fact that equity in the accounts fell below the margin maintenance requirements for these investments and the account requirements. 1217:3-5. FINRA also implied that Respondents improperly advised the customer identified in the Complaint to ignore margin calls. 1310:17-1311:3. This is untrue. The allegations are even more disturbing because they appear to be unsupported by any substantive investigation of the matter.³³ The margin calls were caused by inaccurate pricing data that was provided by Interactive Data to the clearing firm resulting from an inaccurate factor, non-pricing, or a failure to credit the interest and principal payments, or some combination of thereof. Brookstone would alert the clearing firm to the error and the clearing firm would suppress the margin call. 1998:12-2001:15; 2842:24-2845:13; 1510:15-24.

Accordingly, the representatives advised the clients to ignore margin calls as they were based on faulty pricing data. 2886-2887; 1998:12-14. The Respondents sent correspondence to their customers explaining the pricing errors. 2085 and RX 117; 2886:8-2887:7 and CX113.

³³ Mr. Brown testified that he never communicated with the clearing firm to determine if the margin calls were issued in error. 1508:10-14. It is unclear to us how FINRA could expect to satisfy its burden of proof with such a deficient investigation. During FINRA's rebuttal case, Mr. Brown argued that he reviewed the account statement in evidence and did not find any evidence that the bonds were unpriced. 3439:7-3442:10. This testimony is irrelevant and is either another instance of an incompetent and incomplete investigation or a cynical and calculated effort to mislead the Panel. Why is this testimony irrelevant and misleading? Because margin calls are not issued based upon the end of month statement pricing. They are issued based upon day to day pricing obtained from the clearing firm's daily price feeds. Mr. Brown went through the process of reviewing the statements but made no effort to communicate with the clearing firm to ask them to determine if the margin calls were caused by pricing errors. 3475:15-3480:13. Of course, Mr. Brown is not obliged to do so, but we note:

- the issue concerning the margin calls and price feeds arose during the second set of hearing dates in June;
- when Mr. Brown testified in June he was specifically asked if he had contacted the clearing firm to resolve the pricing issue. He had not.
- Mr. Brown admitted to issuing numerous other document requests and 8210 requests to a variety of FINRA members in the time period between the June hearing dates and the February hearing dates (in violation of the scheduling order issued in this case) but not, of course, to the clearing firm.
- FINRA opposed the Respondents motion to compel the clearing firm to present a witness on the issue, and
- then offered testimony that was irrelevant and misleading as stated above.

V. Mr. Locy Adequately Supervised the Customers' Managed CMO Portfolio Accounts

As a preliminary matter, we note that Mr. Walker questioned Mr. Locy regarding his compliance with the firm's document retention policies set forth in the firm's WSPs dated April 1, 2007. The April 1, 2007 WSP was obviously not in effect during most of the relevant review period. It is peculiar, to say the least, and potentially misleading to use a WSP that was not in effect for most of the review period to imply that Mr. Locy was not in compliance with the firm's WSPs. Surely FINRA did not complete its investigation and draft the Complaint in this matter without first obtaining and reviewing the WSPs that were actually in effect during the relevant time period. Since FINRA has the burden of proof with regard to any allegation that Mr. Locy acted in violation of the relevant WSPs, we can only assume that this ploy should be viewed as a tacit admission that Mr. Locy did not, in fact, violate any of the provisions of the pre-April 1, 2007 WSPs that were actually in effect during most of the review period. 2386; 2448:24-2450:4; 2530:23-2532.

That issue aside, FINRA has asserted in the Complaint that Mr. Locy failed to adequately monitor the customer discretionary accounts and failed to supervise the managed CMO accounts. FINRA's Investigator even went as far to claim that there was no evidence that Mr. Locy created any of the compliance checklists or performed any client review of the activities at issue in these proceedings. 1335:13-1336:18. The evidence demonstrates otherwise.

Mr. Locy served in the military and subsequently went on to obtain a bachelor degree in accounting from Southwest State University in Minnesota and previously qualified as a CPA. Mr. Locy is currently the CFO of Brookstone and holds series 4, 7, 24, 27, 53 and 63 securities licenses. During the exam review period of July 2005 through July 2007, he was Brookstone's Chief Compliance Officer and as such he reviewed all of the new account paperwork generated during the exam review period. 2272:5-12. He reviewed the new account documents for each of the three customers of Tony named in the Complaint and believes he reviewed the paperwork for each of the customers of Chris named in the Complaint. 2284:3-14. (Paul Balog was responsible for the initial review of Chris's new account paperwork. 2272:5-12.) On Tony's new accounts³⁴, Dave was the only supervisor reviewing the paperwork, so he would review each page of the application to ensure that all of

³⁴ This was during the FINRA review period only; Dave was not responsible for the initial approval of new account documents for Tony at Archer Alexander. For his compliance review at Archer Alexander, Dave would only review a sampling of the new account documents but for those, he would follow the same process outlined above. 2276-2277.

the data fields were completed and that all of the appropriate disclosure documents were also completed. 2273-2275; 2284-2285. The purpose of the CMO disclosure documents was to ensure that the rep had reviewed certain relevant information with the client, and that the client confirmed that he/she received and understood the materials. 2281:17-21. Dave then reviewed the paperwork (including their investment history, age, investment objectives and risk tolerances) to determine if it was suitable for them to invest in the managed CMO portfolio. 2285:24-2286:5; 2292:21-2293:15; 2303:11-2304:25. Dave's review of the new account forms would be evidenced by his initials on the form. 2298:3-19 and, for example, RX22:2; RX31:2.³⁵ The firm would then copy all of the executed new account forms and disclosures and send them to the client for the client to review and make any necessary corrections. The cover letter would instruct the client to contact the home office, not the representative, with any necessary corrections. 2274:18-25. The clearing firm would also verify the new account information with the clients at least annually. 2288:7-2289:2. None of the customer identified in the complaint ever contacted the firm to correct information set forth on the new account documentation. 2290:18-2291:12.

Dave also performed quarterly, monthly, daily and random reviews. 2395:9-15. Copies of some of the quarterly, monthly and daily review spreadsheets are contained in Exhibit RX100. The purpose of the spreadsheets was to document Dave's performance of the reviews required by the WSPs. 2330:15-2332:14. These spreadsheets were used since July 2005 as a record of the fact that Dave reviewed the materials referenced on the checklist since many of the documents that Dave was obliged to review as part of his compliance review were in an electronic format. 2333:5-8; 2332:19-24; 2335:20-2336:12. As part of Dave's monthly reviews of accounts, he reviewed activity in CMO client accounts to confirm that the activity in the account was proper. 2341:11-2342:13. Several of the accounts at issue were reviewed as part of the random monthly review. 2343:17-2354:2 and RX 100 at 13, 11, 25, 32, 39. Compliance reviews of individual accounts were done on a random basis in order for them to be effective. 2447:12-19.

³⁵ A document by document review of the new account forms to establish that Dave Locy conducted a suitability review of the new account documents and put his initials on the document was discontinued at the recommendation of Hearing Officer Hall. This suggestion was based upon the fact that Mr. Locy testified that he reviewed and signed each of the new account documents. 2301:5-2303:2.

Dave also conducted a compliance and suitability review in connection with the Firm's purchase or sale of CMO bonds. As discussed above in Section III, pages 7-10, this process involved a lengthy discussion with the reps and Mr. Green and the pre-allocation review and post blotter review process. 2407:22-2408:5; 2426 14-21.

Dave was unable to perform a detailed review of every client account before a bond transaction was approved, but he typically would sit with the rep and discuss what the rep was trying to accomplish in the customer portfolios and why it was suitable for the customers that would be participating in the transaction. 2318:2-2319:10; 2397-2398. Dave would go through the particulars of the bond on Bloomberg. 2312:24-2313:4. If Dave had any additional questions he spoke with the broker or with D [REDACTED] G [REDACTED] 2312:8-23. Dave also used Bondtracker³⁶ to conduct a suitability review of approximately 25% to 30% of the accounts identified on the blotter for each transaction. 2457:13-2458:7; 2468:22-2469:18.

If Dave agreed with the reasoning, he approved the trade. 2338:14-2340:19; 2124; 2309:13-21; 2370:19-2372:11; 2309:12-21; 2406:6-8. Dave was free to reject those transactions that he disagreed with. 2166:17-23; 2364:14-2367:12.³⁷ If Dave did approve a transaction he memorialized his approval with his compliance approval stamp on the Bond Packages. 2092-2093; 2340; 2309:22 -2310:17; 2406:9-15.

The compliance review process was the same for the sale of a bond. 2412:15-2412:17. However, where they were replacing one bond with another, Dave's review was also intended to ensure that the quality of the replacement bond was such that it justified the transaction. 2430:9-2431:3. The pricing for the bonds for a purchase or sale was checked against pricing provided by Interactive Data Corporation. 2420:19-2421:2 and 2422:19-2423:2.

VI. The Testimony Elicited By FINRA From the Customers And Customer Representatives is Not Reliable

One of the Panel responsibilities is assessing witness testimony, determining what witnesses to believe, how much weight to give their testimony and making determinations as to the credibility witness testimony. OHO Order 98-13 (C3A970067).

³⁶ Bondtracker is a proprietary system specifically developed by Brookstone to maintain all of the CMO client's information, including their transaction history, customer portfolio information, customer investment profile, investment objectives, and investment tolerances. 2459:21-2460:11.

³⁷ In addition to the review of the CMO trades, there was also a separate monthly random review process for a review of discretionary accounts. 2319:13-2324:9.

There are always a whole host of items to consider when assessing credibility:

- The witness's appearance and demeanor,
- Whether his or her testimony appears probable or improbable.
- Whether the witness's memory is reliable.
- Whether the witness is demonstrably incompetent.
- Any motive the witness may have for not testifying truthfully including financial motive.
- Are inconsistencies or discrepancies in a witness's testimony
- If it is evident that the witness is lying even if he is lying about a small matter, it may indicate a likelihood that a witness's testimony on more substantive matters is not to be trusted.

Credibility also involves an assessment of the whether it is fair to place any weight, or too much weight, on witness testimony that is not based upon firsthand knowledge, and not based upon actual participation in the events about which the witness is testifying. That type of testimony, hearsay testimony, nearly always puts the Respondents at a distinct disadvantage because hearsay testimony can rarely be tested by cross examination.

Why is the credibility of the customer witnesses so critical in this case? There are several reasons. Despite the fact that hundreds of the Respondents' customers accounts invested in the managed CMO portfolios (2270:17-20), FINRA's Complaint identifies only 8 customers for whom, FINRA contends, the investment in a managed CMO portfolio was unsuitable.

- B. B.⁴⁹
- B. C.⁵⁰
- Mr. and Mrs. R.⁵¹
- S. B.⁵²
- L. D.⁵³
- J. G.⁵⁴
- C. P.⁵⁵
- H. P.⁵⁶

Owing to the space limitations for this Post Hearing Brief, a more detailed discussion of the credibility issues with regard to each customer is set forth in the footnotes at the end of this brief.

Two of the customers who "testified," Ms. B. and Mr. B., were demonstrably incompetent at the time of their testimony and at the time that they signed the "customer declarations" prepared for them by FINRA. A third customer, L. D. disavowed any wrongdoing by Chris and accused FINRA of unethical conduct. Neither Ms. P. nor Ms. C. appeared or provided any sworn testimony. In both instances, FINRA called their sons to testify although the sons readily admitted to limited, if any, involvement in their mother's accounts. Mr. C. even admitted that he was pursuing a

lawsuit against Mr. Kline on behalf of his mother while FINRA was pursuing its "investigation". Another customer, Mr. P [REDACTED], had died and so did not testify at hearing. Mr. P [REDACTED] also made a claim against Mr. Kline at the same time that FINRA was pursuing its "investigation". FINRA's Mr. Brown even conferred with Mr. P [REDACTED] attorneys regarding the "declaration" that he prepared for Mr. P [REDACTED] to sign.

The ONLY competent witnesses that appeared at the hearing to offer testimony were Mr. and Mrs. R [REDACTED] and Ms. C [REDACTED]. We believe that, if you carefully weigh the witnesses' testimony, you will agree much of it is not credible and, therefore, does not offer a reliable basis for the Panel to decide the factual disputes in FINRA's favor.

VII. The Managed CMO Portfolios Were Suitable For The Customers Identified In The Complaint.

Reliable evidence in this case supports the conclusion that the Respondents had a reasonable basis for determining that the Managed CMO Portfolios were suitable for each client identified in the Complaint.

A. B [REDACTED] B [REDACTED]

Tony testified that when he first met Ms. B [REDACTED] she was as sharp as a tack. 1776. She asked very detailed questions about investment strategies that Tony recommended and, in particular, about the CMOs. She had the mental capacity to understand the concepts and to ask appropriate questions to get an understanding and she definitely did so. She followed Tony from GunnAllen to Archer Alexander to Brookstone 1775.

As discussed above, Tony's standard practice was to discuss the financial profile, investment history, investment objectives, risk tolerances etc with each customer. Ms. B [REDACTED] was no different. The information on Ms. B [REDACTED]'s new account forms concerning her annual income, her liquid net worth and her investment experience was all provided by Ms. B [REDACTED] and she executed the appropriate forms confirming that information. RX1; 1788-1789. Prior to meeting Tony, Ms. B [REDACTED] invested for many years with her husband, making investment decisions together when she was still a nurse. 1780. Ms. B [REDACTED]

chose income as her investment objective (RX1:2-3; 1792) and a moderate risk tolerance on the "Customer Risk Assessment" form and actually took the time to correct an error on the document. CX19: 6-7. Examples of moderate risk tolerance set forth on the First Southwest form include government agency and government-sponsored entity and mortgage-backed securities. 1798. Ms. B [REDACTED] also completed the new account forms containing various CMO risk disclosures. 1803; RX1:5.

Ms. B [REDACTED] informed Tony that she had \$20,000 in savings, she did not anticipate any significant expenses, and she lived very modestly and shared many living expenses with her companion. She had income from an annuity with a death benefit, and she lived very comfortably on Social Security. 1833-1939. Ms. B [REDACTED] invested roughly \$38,000 of her \$220,000 investable assets (about 20%) for the sole goal of generating enough income to satisfy her minimum IRA distribution. 1839:18-1841:8.

After Tony reviewed all of Ms. B [REDACTED]'s information, met with her repeatedly and reviewed all the available options for her investments, Tony determined that a managed CMO portfolio was suitable to achieve her very limited goal of generating enough income to satisfy her minimum IRA distribution. 1838:5-1841:8. Ms. B [REDACTED] CMO portfolio was designed to provide a source of income to meet that particular goal over time. At the time, interest rate returns on most fixed income products were substantially lower than that he could garner with a structured CMO portfolio (1838) and the CMOs would also continue to pay off income with little likelihood that the coupon would go to zero. 1840.

B. B [REDACTED] C [REDACTED]

Tony testified that B [REDACTED] C [REDACTED] was referred to Tony by her brother who was also Tony's client. Ms. C [REDACTED] expressed her desire to retire from her job at Publix. Ms. C [REDACTED] had about \$300,000 of principal, nearly \$400,000 including her Publix stock. 1853-1854.

After meeting with Ms. C [REDACTED] Tony unequivocally told her that she could not afford to retire on the funds that she had available because she simply would not be able to generate the necessary income she needed to support her current lifestyle. 1849. Tony told her that if she wanted to retire that she should change her lifestyle to lower her need for income, but she declined to do so. 2178-2179. Ms. C [REDACTED] returned for another meeting and advised Tony that she was she was going to retire no matter what. She

could not take working at Publix any longer. 1849-1850. Tony warned her that eventually her money would be depleted and she would find herself back at work or living on social security. 1855. Tony also explained to her that it was not possible to produce the income at the level she needed without risk. 1849-1850. She understood that she had to take more risk to accomplish what she wanted to accomplish and was willing to take those risks. 2178-2179. At that point, Tony reviewed the investment options with her: Tony did not believe that investing in the stock market was a viable strategy and Ms. C was not interested in CDs or purchasing rental real estate. Eventually they settled on the CMO strategy. Mr. Turbeville reviewed each of the disclosures contained in the Brookstone CMO Disclosure Form (RX 54:4) with Ms. C including item number seven. Item seven specifically states that, for inverse floating CMO's, rising rates will lower interest and extend the principle beyond the average life anticipated which may increase or decrease your effective yield. Tony reviewed this issue with her during his whiteboard presentation and later when Ms. C was executing the paperwork. 1885-1886. Tony was very clear to her that the CMO strategy would not provide her with the income that she was demanding and that eventually her principal would be depleted over time no matter what. 1857. So, in light of Ms. C's refusal to abandon her intention to of retiring, and her full understanding of the limitations and risks associated with the strategy, Tony determined that she was suitable for a modest CMO managed portfolio. 2223. Ms. C did not tell Tony that she needed to access her money at any time. Had she, Tony would not have placed her in CMOs. 1884-1885.³⁸

C. M and M R

Tony testified that he met the R at a seminar. The seminars were intended by Tony to be very non-pushy and educational in nature and covered a wide range of issues, including Medicaid planning to pay for nursing home care. 1758:10-18; 1905-1906. Tony also prepared a Financial Profile for M

³⁸ Tony bases his assumption that Ms. C was misinformed by FINRA upon his recollection that Ms. C focused on a final maturity date of 2030. This bit of misinformation made it obvious to Tony that somebody was speaking to Ms. C that did not fully understand the securities. 1888. Tony discussed maturity date with his customers by asking them how many people keep their mortgages for 30 years. The customers would chuckle, acknowledging that very few people keep the same mortgage for 30 years. While there is a final maturity date, it is very likely that a large portion of the underlying mortgages in that bond would pay off well in advance of the final stated maturity date. 1889-1890.

R (CX 334) which was intended as a starting point for further discussions with Mr. R concerning his investment goals and options. 1927:24-1929:13; 1936:11-1938:9. Again Tony engaged in a series of conversations and presentations with prospective clients so the client could make an informed decision about his or her investment objectives and strategies. 1911-1913. The R expressed an interest in opening an account and Tony followed his usual account opening process explained above. 1911. After extensive discussions, which included the detailed presentation concerning the CMO portfolio and a comprehensive review of the new account forms and disclosures, the R decided to open a CMO managed portfolio accounts with Tony. 1911:4-7; 1948:7-12. The new account paperwork indicates that they had an annual income in excess of \$100,000, a liquid net worth in excess of \$500,000, an investment objective of "aggressive income" and a risk tolerance of "aggressive".

Tony believed that the CMO portfolio strategy was suitable for the R given their significant income, ready liquidity, substantial assets and their desire to achieve the growth of their investment portfolio. Panelist Hancock noted that the financial plan indicates that one of the investment concerns was liquidity but that Tony had already testified that CMOs are not very liquid. 1940-1941. Tony explained the R desire for liquidity was not dependent upon the CMO strategy. Mr. R managed his various businesses³⁹ and Mrs. R was employed in a fairly high position in the Hardee County Health Department with the salary and benefits that comes from such employment. 1921:1-16. In short, Mr. R would still have the liquidity he desired. 1940-1941. The investment strategy was only taking a portion of Mr. R investment capital and using that to fund the CMO portfolio. Utilizing the investment capital for a managed CMO portfolio would not change Mr. R access to cash from his cash businesses, his bank accounts, or his substantial portfolio of mutual funds and fixed income securities which remained at Merrill Lynch. 1954-1955. Furthermore, the fact that the R were not intending to use the CMO portfolio to provide liquidity is evidenced by the monthly account statements. Those statements demonstrate that the R were not withdrawing the cash generated by the CMO portfolio but were,

³⁹ Mr. R had a tremendous amount of cash as reflected in the financial profile. Mr. R was an owner of three car washes (1917:19-23) and a rental property (1926:6-8) and Mr. R advised Tony that he liked cash businesses because he was divorced three times and he always wanted to make sure that he had cash tucked away. 1917:7-12.

instead, reinvesting the cash generated by the portfolio back into the portfolio. RX48-RX51. The R█ were apparently so pleased with the performance of the investment that they contributed an additional \$600,000 to the CMO portfolio which brought their total investment to \$900,000. 1949.

D. S█ B█

Chris started working with Mr. B█ in 2001 and met with him about ten to twelve times before Mr. B█ decided to open an account.⁴⁰ As part of his standard account opening process, Chris spoke with Mr. B█ concerning his investment experience, sources of income, assets, education, business experience and investment objectives and needs. 2746:21-2747:5. Mr. B█ was married with no children, retired, had an annual income of \$50,000 to \$100,000 and a liquid net worth in excess of \$1 million dollars. 2747:14; 2768:17-24. Mr. B█ chose to invest about 10% of his total liquid net worth with Chris. 2755:15-21. He was an experienced investor with over 10 years investment experience and he was invested in annuities, high yield junk bond funds and real estate. 2747:21-2748:24. He owned residences in Florida and Illinois. 2750:20-22. Mr. B█ had over \$900,000 in annuities purchased through another broker. Mr. B█ was a well read, intelligent and very thoughtful man that lived modestly but was passionate about his various charitable causes and his faith. 2751:21-2752:5. Mr. B█ explained that his primary investment objective was simply to generate as much income as possible so that he and his wife could donate to their various charitable causes. 2754:18-22.

Consistent with this limited objective, Chris concluded that it would be suitable for Mr. B█ to pursue a managed CMO portfolio. The strategy performed well for a time but as the interest market changed the performance declined. Chris, consistent with his standard practice, called Mr. B█ monthly and discussed with him the increases in the Fed Funds rate and the increases affect on the bond coupons. 2769:10-20. Also, as referred to above, Chris sent numerous letters to Mr. B█ describing his

⁴⁰ FINRA has never produced Brookstone New Account forms executed by Mr. B█ so the only new account forms available to Respondents were the account forms executed by Mr. B█ when he opened his account in 2001. Mr. Kline has testified that the documents contained in CX 316 are clearly not the account documents because they have not been executed. Executed documents would have been required by the clearing firm before any activity occurred in the transferred accounts: 2766:20-2767:19.

assessment of the portfolio and his recommendation that they adjust the CMO portfolio accordingly.
CX315; CX318; CX 320.⁴¹

E. I. D.

As discussed elsewhere in this brief, Mr. D. provided Respondents with an affidavit (sworn under oath and before a notary) that was prepared by Mr. D. with the assistance of Respondents' counsel Liam O'Brien and signed by Mr. D. on May 23, 2011. RX96.

The Affidavit contains statements that contradict the statements made in the declaration that Mr. Brown prepared. 1630-1631. Mr. D. acknowledges that he met with Chris several times to discuss his financial objectives; that Chris reviewed the account paperwork and the CMOs disclosures with Mr. D. in detail; that the paperwork accurately reflected his extensive investment experience and investment objectives; and that Chris answered any questions that he had before he executed the paperwork. The new account paperwork indicates that he had an annual income of \$65,000, a liquid net worth of \$550,000, an investment objective of "aggressive income" and a risk tolerance of "moderate" to "aggressive". RX18:3. Based upon the foregoing, Chris determined that the managed CMO portfolio was suitable for Mr. D. We note that Mr. D. affidavit states that Mr. D. had no problem with the way his account was handled by Chris; Mr. D. believes that FINRA is acting in an irresponsible and improper manner; and Mr. D. believes that Chris Kline is being wrongly accused. RX 96.

The affidavit also includes what could only be described as truly disturbing allegations of misconduct by FINRA's investigator. Namely, the affidavit states that:

- FINRA bombarded Mr. D. with a steady stream of phone calls.
- Mr. D. did NOT assist Mr. Brown in the preparation of the "declaration".
- The FINRA declaration does not accurately reflect his investment experience, investment objectives, willingness to assume risk nor his understanding of the products that he invested in.

⁴¹ Mr. B. never advised Chris why he was closing the account but, in addition to the difficult market environment, it may have been the fact that Mr. B. received a misleading analysis from his accountant, Mr. D. 2801:2-2802:19. The analysis set forth in Mr. D.'s letter to Mr. B. makes clear that Mr. D. was treating the investments as if they were traditional bond investments and not mortgage backed securities. Id.

If Mr. D█████ is to be believed, it appears that he may have been pressured by an unscrupulous and aggressive investigator to make false allegations against Chris. Moreover, the D█████ affidavit includes assertions that are consistent with the information that Mr. D█████ provided in the account opening and disclosure documentation that were executed by Mr. D█████ for his managed CMO portfolio. RX96.

F. C█████ P█████

Chris' interactions draw a completely different picture of C█████ P█████ than the one depicted by FINRA. Chris followed his standard account opening process and account form review with the P█████ 2667; 2671-2672. Mr. and Mrs. P█████ were referred to Chris by their insurance agent. 2661:2. Mr. P█████ was an educated man with extensive experience as a small businessman. 2661:18-20; 2662:5-10. Mrs. P█████ had obtained a master's degree and was a retired teacher. 2662:11-20. The P█████ had annual income of \$50,000 to \$100,000, a liquid net worth of \$2.1 million. 2666:5-12. The Pascos had invested together for over 30 years and extensive investment experience which included other brokerage accounts with a variety of stocks including some long held positions which they referred to as their "legacy" stocks. 2662:12-20. Their primary investment objective was to generate a large degree of cash flow that they could gift to their adult children and to also pay for their grandchildren's college educations. They were unwilling to sell their legacy stocks but the dividends being generated by these positions was not enough to generate the cash flow that they desired. 2665; 2880:20-2881:20. They understood the managed CMO portfolio strategy and also understood the risks associated with the strategy. 2673:2-2675:9. In light of the foregoing, Chris thought the CMO portfolio with a prudent amount of margin would be a suitable investment for the P█████ because it offered a reasonably stable way of generating cash flow for them to make the gift distributions that they wished, after interest payments on margin, without liquidating the legacy stocks. 2665:13-20.

Following the death of Mr. P█████, Chris continued to communicate with Mrs. P█████ to gauge her understanding of how the strategy was performing and to determine if she wished to change either the strategy or her investment objectives. 2675:16-2676:23. Ms. P█████ never indicated that she did not

understand the investments nor did she ever include her children in the management of her investments. In fact, Ms. P████ never indicated to Chris that she was upset or concerned. 2890:15-17. However, the children apparently became upset with the account performance and transferred the accounts in early August 2007.⁴²

G. J████ G████

Chris Kline spent a considerable amount of time learning about the G████ investment experience, sources of income, assets, education, business experience and investment objectives and financial needs. 2686:16-24. Mr. G████ was a Yale graduate and an experienced businessman. 2691:10-23. Mrs. G████ was a real estate professional and was actively involved with their investment decisions. 2693:9-19. The G████ investments included equities, variable annuities and some equity based mutual funds. 2687:22-24. They were specifically seeking alternatives to the stock market having experienced stock market losses in the 2000-2001 stock market crash. 2688:21-24; 2694:5-16. Their goal was to generate significant income in order to sustain their current spending habits (2688:5-8). The G████ were looking for returns greater than those available through CDs and traditional bonds and annuities. The G████ were also unwilling to pursue an equity market strategy. 2695:11-2696:17. Their GunnAllen brokerage account paperwork indicated that they had annual income of \$95,000 and \$750,000 in liquid net worth with an investment objective of high income and a moderate risk tolerance. RX68:2. In light of the foregoing, Chris determined that the CMO strategy presented a suitable strategy for the G████ to generate the income they desired. Mrs. G████ opted to continue with the strategy

⁴² It was shortly after the loss of the P████ account that Chris sent a poorly worded email to Mr. G████ and Mr. U████ (CX270) which could be misread to imply that U████ and G████ were actually managing the investment decisions of the Kline customer accounts. However, Chris' testimony and that of the other Respondents is that Chris was clearly the person managing the investment decisions of his clients' managed CMO portfolios. Mr. G████ and Mr. U████ were managing the administrative functions of the portfolios. The proper context of the use of the word "management" is key to understanding the intent of the email. Chris' extensive knowledge of the products as demonstrated through his testimony and the correspondence with his clients (e.g. his emails to Ms. B████ CX 273, pages 9-11) make clear that the strategy and the clients' portfolios were managed by him. 2893:3-2894:2.

following the death of her husband.⁴³ Chris further testified that Mrs. G. told him that she felt that that her losses were a result of a very difficult market and were not caused by Chris. 2715:2-7.

H. H. P.

Chris met with Mr. P. between three and five times before Mr. P. became a client. 2718:2-4. As part of Mr. Kline's standard account opening process, Chris spoke with Mr. P. concerning his investment experience, sources of income, assets, education, business experience and investment objectives and needs. 2716:10-17. Mr. P. had an annual income of \$150,000, a liquid net worth of \$2 million and an aggressive investment style. 2725:20-2726:7. Mr. P. derived income from his investment portfolio, a charitable remainder trust and his real estate holdings. 2716:20-2717:4. Mr. P. was fully retired, having sold his textile manufacturing business. He had extensive investment experience as evidenced by his Smith Barney account which held hundreds of equities including penny stocks, and eventually transferred his account with over one million dollars in margin. 2717:19-2718:20 and 2721:4-5. Mr. P. was dissatisfied with his stock portfolio performance and had suffered as a result of the stock market collapse in 2001. He was also looking to generate sufficient distributions to cover the insurance premiums on his irrevocable life insurance trust. 2719:6-21.⁴⁴ In light of this limited objective, and Mr. P.'s substantial wealth, Chris recommended the CMO portfolio as a suitable method of generating the revenue needed to pay the premiums for the irrevocable life insurance trust. 2719. Mr. Kline has no recollection of Mr. P. complaining about the performance of his account but at some point Mr. P. closed his account. Mr. P. also filed a complaint with the firm, which was denied, but never pursued a claim. 2742-2743.

VIII. Respondents' Information Sharing Arrangement With D. G. And B. U. Did Not Violate Federal Securities Laws

⁴³ When Mrs. G. transferred her account to Brookstone, her daughter assisted her with the execution of the account paperwork and, in fact, also executed the paperwork herself. As noted above, Mrs. G.'s daughter was previously employed in finance.

⁴⁴ Mr. Kline remembers Mr. P. as a thoughtful and intelligent man that asked various questions exploring the difference between CMOs and traditional debt securities and the nature of the floating coupons. 2729:22-2730:6. Of course, Mr. Kline also followed his standard procedure of reviewing all of the CMO and margin risks and risks disclosure forms with Mr. P. 2735-2739. Mr. Kline contacted Mr. P. on a monthly basis to ensure that he understood what was happening in their accounts and to determine if they had any questions or concerns, discuss economic changes, interest rate changes. It was also an opportunity for Chris to ascertain any changes in the clients' investment objectives. 2740.

Enforcement's Complaint alleges that Brookstone was required to allow customers to opt-out of the sharing of information with D■■■■G■■■■ and B■■■■U■■■■ employees of Crocker Securities. However, Enforcement's position is inconsistent with SEC Reg. S-P. The SEC adopted Reg. S-P to implement notice requirements and restrictions on financial institution's ability to disclose non-public customer personal information to third parties.⁴⁵ All brokers, dealers, and investment companies, such as Brookstone, are required to conform to Reg. S-P. 17 CFR §248.1(b). Under Reg. S-P, broker-dealers must not disclose non-public personal information about their consumers to nonaffiliated third parties, unless they provide clear and conspicuous notice to each customer which explains the consumer's right to "opt out" of the disclosure. 17 CFR §248.7(a)(1).

Reg. S-P defines non-public personal information as "personally identifiable information". 17 CFR §248.3(t)(1)(i). The information available to U■■■■ and G■■■■ via the BondTracker VPN (virtual privacy network), was limited to data fields that were not subject to privacy rules. Moreover, Respondent Locy obtained an affidavit from the vendor that programmed and managed the system confirming that the sensitive client data was password protected. 2356:22-2359: 18; RX103. However, even if some of the data could be categorized as non-public information, Enforcement's claims are wrong as a matter of law, namely Section 248.14 of Reg. S-P or 17 CFR 248.14(a).⁴⁶

⁴⁵ Reg. S-P was promulgated in accordance with Section 504 of the Gramm-Leach-Bliley Act which required the SEC and other federal agencies to adopt non-public information disclosure rules.

⁴⁶ Section 248.10 of Regulation S-P, or Rule 10 as it is commonly called, provides conditions for disclosure of nonpublic personal information. Rule 10 states that before a financial institution discloses nonpublic information about its customers they must: provide the consumer with an initial notice, provide the consumer with an opt out notice, and give the consumer a reasonable opportunity to opt out of the disclosure. 17 CFR 248.10(a)(1). However, the statutory text and applicable case law provides certain exceptions to the notice and opt out requirements.

Section 248.14 of Regulation S-P, also known as Rule 14, provides an exception to the notice and opt out requirements for processing and servicing transactions. As is relevant to the instant matter, Rule 14 states that Rule 10, explained above, does not apply "if you disclose nonpublic personal information as necessary to effect, administer, or enforce a transaction that a consumer requests". **17 CFR 248.14(a)**. The Rule further defines "necessary to effect, administer, or enforce a transaction" as to mean: "as is required, or is usual, appropriate, or acceptable method... to carry out the transaction... in the ordinary course of providing the financial service or financial product". 17 CFR 248.14(b)(2)(i). Brookstone's privacy policy statement provided that the firm would not disclose data to persons other than those persons necessary to effect transactions for customers. 2547. Respondent Locy noted that this was consistent with Regulation SP. Id.

A financial institution is not required to notify a customer of disclosure of non-public information if the disclosure was a necessary and acceptable method of completing the transaction the customer requested or agreed to. The type of information disclosed by Brookstone, was necessary to effect the purchase of CMOs in the customer accounts. 2469. The information provided to G and U was necessary for the identification and allocation of CMO bonds. Id. It is solely for this reason that information was disclosed to third parties (Green and Utne). G was effecting inter-dealer transactions for the purchase of CMOs on behalf of Brookstone. U was G's assistant. Although, U's role was strictly administrative; none of the services he performed required a license nor did he speak with customers or enter orders, his services were necessary. 2377:10 -2378. This sharing of information was necessary for Brookstone to complete the transaction requested by their customers. Therefore, no Reg. S-P violation has occurred.

In addition, the method in which Brookstone disclosed this information is acceptable. The information was released on a VPN, virtual privacy network, which provided secure access to those with the proper credentials. Additionally, G and U executed confidentiality agreements. See 2548-2552 referring to CX306:8-9, §10. Federal case law supports this conclusion.⁴⁷

The facts in our case are even stronger than those in Dunmire, the leading federal case on this issue. In Dunmire, an estranged wife was seeking to settle a debt, Morgan Stanley was aiding in the collection effort. Id. Our matter deals directly with the purchase and sale of securities. Without the disclosure of information to U and G, the inter-dealer transactions that were vital for Brookstone to purchase CMOs on behalf of its customers could not have occurred. Brookstone could not have effected these transactions on behalf of its clients. As such, the disclosure of information to G and

⁴⁷ The most frequently cited case pertaining to a Rule 14 exception is Dunmire v. Morgan Stanley DW, Inc., 475 F.3d 956. In Dunmire, Morgan Stanley, the financial institution, served a demand letter on Dan D. Dunmire on behalf of his estranged wife. Id. at 957. The demand letter contained non-public information and Dunmire alleged that Morgan Stanley's conduct violated the Gramm Leach Bliley Act. Id. at 958. The Court of Appeals however, cited Regulation S-P's exception in Rule 14 which permits financial institutions to disclose nonpublic personal information as necessary to effect, administer, or enforce a transaction requested or authorized by the customer. In dismissing Dunmire's claim, the court reasoned that the demand letter was "an appropriate and acceptable method of settling or collecting debt it believed Dunmire owed- a valid exception under the GLBA. Id. at 961.

Unsuitability falls squarely under Rule 14 of Regulation S-P. Enforcement has no authority to second guess federal securities regulations and related case law. Accordingly, Brookstone did not violate Regulation S-P due to the Rule 14 exception and due to insufficient data to be considered a breach.

IX. Damages

A. The Appropriate Method For Calculating Damages

Assuming, for argument's sake, that the Hearing Panel finds that "restitution" for the customers named in the complaint is appropriate, what is the proper method for calculating such damages? The proper calculation of damages should be done in harmony with federal securities case law and FINRA securities arbitration decisions.

An unsuitability claim is a subset of the ordinary Section 10(b) fraud claim.⁴⁸ The Federal courts have determined that the appropriate measure of damages for unsuitable transactions is "the difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant's conduct. Or in other words, the difference between the amount parted with and the value of the thing received." Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); see also Smith v. Bolles, 132 U.S. 125, 10 S. Ct. 39, 33 L.

⁴⁸ Unsuitability requires a showing that a broker recommended or purchased securities for an investor knowing that they were unsuitable for the investor's needs. See 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, 600-01 (2d Cir. 1978). A showing that a broker acquired unsuitable securities in conjunction with facts establishing misrepresentation or other intentionally or recklessly improper conduct is generally actionable as a Section 10(b) securities fraud claim. *Id.* Civil liability under Section 10(b), and the consequent recovery of damages, is based on an implied private right of action. See Basic Inc. v. Levinson, 485 U.S. 224, 230-31 (1988); Herman & Maclean v. Huddleston, 459 U.S. 375, 380 (1983); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). As such, neither Section 10(b) nor Rule 10b-5 specifies a measure of damages when a private plaintiff proves a violation. However, courts refer to Section 28 (a) of the Securities Exchange Act of 1934, the only statutory guide for determining damages for private right-of-action civil liability under the Exchange Act. Section 28 (a) provides that a plaintiff suing under the Exchange Act may not recover "a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a). The Supreme Court has "clearly interpreted § 28(a) as governing the measure of damages that are the permissible under § 10(b)." Randall v. Loftsgaarden, 478 U.S. 647, 663 (1986) (citing Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972)). However, Section 28(a) does not delineate the meaning of "actual damages." *Id.* at 662. Accordingly, the federal courts have developed damages calculations based on common law principles, primarily those from the torts of fraud, deceit, and misrepresentation. See Harris v. American Inv. Co., 523 F.2d 220, 224-25 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); Mitchell v. Texas Gulf Sulfur Co., 446 F.2d 90, 97 (10th Cir.)

Ed. 279; Sigafus v. Porter, 179 U.S. 116, 21 S. Ct. 34, 45 L. Ed. 113. This is also known as the "net out of pocket loss" Federal courts have repeatedly held that an "out-of-pocket" rule is the generally appropriate measure of damages for a violation of Section 10(b). See Randall v. Loftsgaarden, 478 U.S. 647, 661-62 (1986); Id. at 668 (Blackmun, J., concurring) ("Normally, the proper measure of damages in a § 10(b) case is an investor's out-of-pocket loss..."); Kronfeld v. Advest, Inc., 675 F. Supp. 1449, 1455 (S.D.N.Y. 1987) ("Generally, a plaintiff's damages in an action under Rule 10b-5 are determined by using an 'out-of-pocket' measure.") (citing Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168 (2d Cir.1980)).⁴⁹

In this vein, "out of pocket" loss does not include lost profits. Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965); Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962). See also Sigafus v. Porter, 179 U.S. 116, 45 L. Ed. 113, 21 S. Ct. 34 (1900); Chandler v. Andrews, 192 F. 543 (2d Cir. 1911). Despite the clear roadmap that the Hearing Panel would have to follow in order to calculate "out of pocket" loss, the Hearing Panel lacks sufficient data to calculate damages in accordance with the Federal Rule.

B. Respondents Were Denied Access To Data Necessary To Calculate "Out of Pocket Losses"

Respondents did not have access to account statements which would be necessary to make such "out of pocket loss" calculations. 3399:13-3402. The Hearing Panel has heard substantial witness testimony that the calculations of gain/loss were inaccurate as a result of this deficiency. See generally 2920:16-2935; 3031:17-3033:10. This testimony indicated that

⁴⁹ In re Warner Communications Securities Litigation, 618 F.Supp. 735, 744 (S.D.N.Y.1985), aff'd, 798 F.2d 35 (2d Cir.1986)); see also Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974); Wolf v. Frank, 477 F.2d 467, 478 (5th Cir.), cert. denied, 414 U.S. 975 (1973); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); see Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) ("the correct measure of damages . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct"); Lawton v. Nyman, 327 F.3d 30, 42-43 (1st Cir. 2003).

Respondents did not have access to account statements from Kovack Securities and GunnAllen Financial. Id. Also, the testimony indicated that a limited number of Archer Alexander account statements were available (for the time period when First Southwest was Archer Alexander's clearing firm). See generally 3020-35. This makes calculating "out of pocket loss" impossible because most, if not all, of the named customers associated with the complaint had been clients of Respondents Turbeville and Kline prior to their association with Respondent Brookstone. See generally 2920-35; 3020-35.

C. Enforcement's Loss Calculations Are Inaccurate

By limiting their calculations to the "relevant" time period of the Complaint, Enforcement fails to follow the "out of pocket loss" standard. Moreover, the Hearing Officer intuitively honed in on this defect in Enforcement's loss calculations during the rebuttal testimony of Mr. Brooks Brown for FINRA during an exchange with the witness. "If I understand your testimony, what that number says is, for example, and I think this is what you're getting at, is a bond -- and let's just use round numbers -- a bond could have been purchased back in 2004 for 100. By 2005, where you pick it up, it's now worth 300, but then in 2006 it sold for 200. Under your calculations, it looks like \$100.00 loss, whereas a lot of people would look at that and say it's a \$100.00 gain." To which Mr. Brown replied, "That's accurate." 3466. Enforcement's calculations are craftily calculated to capture customer lost profits. By limiting their calculations to the period of June 20, 2005 to July 31, 2007, the calculations zero out any gains which were in the customer accounts prior to June 20, 2005. 3463.

D. Even Respondents' Customer Gain/Loss Calculations Are Incomplete Due To Insufficient Data

Although Respondents' gain/loss calculations contained a somewhat longer period of account activity, the calculations were also limited by insufficient data regarding account performance prior to the accounts being opened at Brookstone. Respondent Kline testified

regarding a simple in/out account analysis of customer statements. See 2923-2942, referring to RX178, RX181, RX182, RX183 and RX184. The analysis indicated the following losses among the named customers: P [REDACTED] (\$443,060.22), G [REDACTED] (\$366,741.05), B [REDACTED] (\$73,935.85), D [REDACTED] (\$4,352.62), and P [REDACTED] (\$285,103.44). However, Mr. Kline testified that although accurate this analysis was incomplete because it did not include the prior periods in which these customers had invested with him at firms other than Brookstone. 2923-2942.

Similarly, Mr. Turbeville testified regarding a simple in/out account analysis of customer statements. See 3024-3032 referring to RX178, RX180 and RX181. The analysis indicated the following losses: C [REDACTED] (\$33,299.90), B [REDACTED] (\$836.81) and R [REDACTED] (\$393,062.44). However, Mr. Turbeville testified that although accurate this analysis was incomplete because it did not include the prior periods in which these customers had invested with him at firm other than Brookstone. 3024-3032. Essentially, Mr. Kline and Mr. Turbeville stated that these analyses were not an accurate measure of "out of pocket" losses.

E. "Restitution" Is Not Permitted For Customers Who Have Settled Their Claims

Assuming, solely for the sake of argument, that the Hearing Panel finds that "restitution" for the customers named in the complaint is appropriate, the customers that have settled their claims should be excluded from such a calculation. Mr. Turbeville noted in his testimony that Respondent Brookstone has settled all claims with customers C [REDACTED] and R [REDACTED] 3019-3040. Despite Enforcement's contrary assertions 3040-3045, under Florida law the R [REDACTED] signed a valid general release of all claims against Respondents Brookstone and Turbeville.

Florida courts enforce general releases to further the policy of encouraging settlements. Numerous Florida cases have upheld general releases, even when the releasing party was unaware of product defects and negligence. See Hardage Enters., Inc. v. Fidesys Corp., N.V., 570 So. 2d 436 (Fla. 5th DCA 1990) (enforcing a general release even though the party

discovered the negligence after executing the release); Braemer Isle Condominium Ass'n, Inc. v. Boca Hi, Inc., 632 So. 2d 707 (Fla. 4th DCA 1994) (enforcing general release although party did not discover alleged defects until after executing the release). The suggestion that Brookstone does not have a valid release of all claims is ridiculous and contrary to Florida law.

X. Conclusion

Based upon the foregoing, Respondents respectfully request that the allegations set forth in the Complaint as against all of the Respondents be denied in their entirety.

⁴⁹ Ms. B. was presented as a witness but sadly, Ms. B. was simply not competent to testify. 30:22-10. When questioned Ms. B., testified that she could not recall any discussions that she had with Tony Turbeville in 2006. 232:21-233:2 Ms. B. testified that her memory was in decline for several years and she was unable to say whether her memory was reliable in 2008. 232:4-20. Why did we specifically focus Ms. B. on the year 2008? Because that is when FINRA's Investigator Mr. Brown had Ms. B. sign a declaration that he had prepared for her. C23. As further evidence of her dementia, Ms. B. did not know whether she wrote the declaration and could not recall who wrote the document. 233:19 – 234:7 This testimony alone calls into question the reliability of her customer declaration. However, there are other reasons to question the accuracy of the declaration.

Mr. Brown issued an 8210 request to obtain a Ms. B. Merrill Lynch account records. He had no recollection of obtaining documentation indicating Ms. B.'s investment objectives and risk tolerance. 1564-1565. The Merrill Lynch account statements include certain high yield bond funds that were consistent with Ms. B.'s desire to generate high income but inconsistent with the declaration prepared for Ms. B. 1567 – 1570. And yet, despite having this information concerning Ms. B.'s prior investments, Mr. Brown testified that he did not discuss Ms. B.'s prior investment in high yield bond funds with her. 1572 – 1573.

At the time she testified at hearing, she was no longer competent to testify on the issue. Ms. B. even told Brooks Brown that her memory was bad. Her customer declaration specifically states that, "I do not recall anything specific about the meeting, as my memory is not as sharp as it used to be?" RX8. And yet Mr. Brown testified that he gave no thought to ascertaining whether Ms. B. was competent to sign a statement nor did he attempt to assess the mental competence of ANY customer that he prepared declarations for. 1575; 1581-1582.

Mr. Brown has testified that the reason he obtained the customer declarations was because "There was fear on my part and my management that if we didn't take some step to memorialize what they were telling us at the time, that down the road their memory could be impaired". 1130 – 1131. Arguably, once FINRA understood that witnesses might not be available for hearing, it was incumbent upon Mr. Brown to ascertain the competence of witnesses at the time that Mr. Brown was drafting the customer Declarations. Mr. Brown made no effort to do so. See 1575, 1581 – 1582. Respondents' counsel secured testimony regarding Ms. B.'s lack of capacity in less than 5 minutes. When questioned, Ms. B. testified that she could not recall any discussions that she had with Tony in 2006 and that she had no idea if her memory was any better in 2008. 232-234. Another question that the panel must ask is this: If FINRA determined that there was a great risk that the witnesses may not being available or competent to testify, why did it take four years to bring this matter to a hearing? Is it not common sense that those type of delays will likely result in the unavailability of witnesses and the spoliation of evidence? If FINRA fails to properly obtain and preserve reliable evidence and FINRA does not pursue this matter with any urgency, when it is well within FINRA's power to do so, then it should be FINRA that is burdened with the adverse inference that the "evidence" it is presenting is not sufficiently reliable to be considered by the Panel. The equitable principle of laches recognizes that a defendant in an action can lose access to evidence, witnesses, and consequently a fair chance to defend himself if the prosecuting party does not deliberately preserve evidence and act expeditiously.

Unfortunately, this is not an issue that is limited to Ms. B[REDACTED] testimony alone as we shall see when we examine Mr. B[REDACTED] testimony.

If Ms. B[REDACTED] was no longer competent to testify and if she was not competent at the time Mr. Brown prepared Ms. B[REDACTED]'s so-called "Declaration", the only competent evidence upon which the panel should rely is Mr. Turbeville's testimony and the account paperwork that was completed by Ms. B[REDACTED].

⁵⁰ There are a myriad of reasons why Ms. C[REDACTED] is not a reliable witness. Let us start with this one. Ms. C[REDACTED] produced from her personal records certain opening account documents that she testified were from about February 2006. 183:20-25; CX14:8-9. She says she received these documents from Brookstone, corrected them and sent them back to Brookstone. 183:6-9. In these corrected documents she indicated that she was interested in Stability and Income, that she only had 5 years of investment experience, she was supposedly a conservative investor, and that her primary investment objective was income. CX14: 8-9. Brookstone had no record of these corrected documents. Ms. C[REDACTED] allegedly found these records in her files and turned them over to FINRA. 184:15-23. Ms. C[REDACTED] testified that she made the changes to these documents, but did NOT initial the changes, and did NOT sign the documents before sending them back to Brookstone by regular mail. CX 14:8-9; 185:17-25; 62:11-13. She testified under oath that she thought Brookstone would make the corrections and send her new documents. 185:1-5. The appearance of these corrected documents is curious because, not too long after Ms. C[REDACTED] allegedly went through the trouble of correcting these documents and sending them back to Brookstone, Ms. C[REDACTED] proceeded to complete and execute the same exact opening account forms but this time Ms. C[REDACTED] included substantially different information. CX6:8; 184:6-14.

In the May 2006 opening account documents, Ms. C[REDACTED] actually signs the documents, and she indicates that she has more than 10 years experience investing, that she is not a conservative investor but rather her investment objective is aggressive. CX 6:8. Did we mention that she actually signed the May 2006 documents? That is not nearly half of it. She edits the opening account documents and then signs them. See Ms. C[REDACTED] edits on CX6:8 and 15. When asked why she would edit and sign documentation in May 2006 that was so different than the documentation she allegedly corrected and allegedly sent back to Brookstone in February 2006, what does she say? I don't know, (64:8), I did not follow up on them (62:11), and again, I do not know why (68:1). "When you went in and signed all that account paperwork in May of 2006, did you ask them why they didn't make any of the changes you made in these forms (February 2006)? No. I did not, As far as I was concerned, I made the corrections, I sent them in and it's like out of sight out of mind. You put them away, you don't think about them." 186:19-187:1. What is more likely? That Ms. C[REDACTED] completely forgot about the February 2006 paperwork or that the February 2006 paperwork that she provided to FINRA was fabricated to make her claim appear more credible? Ms. C[REDACTED] clearly demonstrated with the May 2006 opening account documents that she was capable of editing her documents and ensuring that those edits were memorialized before she would sign them. FINRA did not bother to question this fabricated evidence. The Panel has no obligation to be equally negligent.

Let's set aside the issue of fabricated evidence because there are several ways we can demonstrate that Ms. C[REDACTED] is not a credible witness. For example, Ms. C[REDACTED]'s repeatedly asserted that she did not take the time to read all of the opening account documents and that she signed documents simply because Tony told her that she needed to sign them. 53:11-16. But we know that is not true. As discussed above, Ms. C[REDACTED] not only read the documents, she edited them and initialed her changes. Moreover, Ms. C[REDACTED]'s testimony constantly changed on this issue. She admits to reading and editing some opening account disclosures. 146:2-12. She tacitly admits throughout her testimony that Tony reviewed documents with her paragraph by paragraph. 148:10-25. She testified that she would not have initialed next to paragraphs that she did not understand or executed paperwork if Tony refused to make the edits that she had requested. 146:8-12. She even testified that, with regard to all the opening account documentation, if she wanted to make changes to a document or did not understand a document, she would not have signed them. 146:13-18. These contradictory statements render Ms. C[REDACTED] testimony unreliable and call into question the witnesses' veracity on any other issue. If that were not enough to completely discredit her, Ms. C[REDACTED] changed her testimony on another critical issue under cross examination.

Ms. C[REDACTED] testified on direct that she did not want any risk and that she had no recollection of ever discussing risk with Tony (42:14; 44:1), yet on cross examination she admitted that Mr. Turbeville actually did discuss risk with her. 64:8. She also testified that Tony read the CMO risk disclosures to her (69:8) including the

disclosure that warned that if she liquidated the portfolio during a steep inverted yield curve, she would suffer substantial losses and that she understood what was meant by substantial losses. 153:1-6. She even initialed the disclosure which acknowledged that she received The Investor's Guide to Collateralized Mortgage Obligations which contains a full range of risk disclosures. 80:7.

Ms. C's testimony on the issue of the Investor's Guide is equally incredible. Ms. C originally advised FINRA that she did not recall reviewing any CMO disclosures. 123:11-16. She later testified that she had no recollection of having received the Guide from Tony. 169:3-12. The complete Investors Guide may be found at RX72. While Ms. C had no recollection of receiving it, she most certainly did receive it because Ms. C produced a portion of the Guide from her personal records and provided it to FINRA during their investigation. 156:5-10. While she had no recollection of receiving the complete guide, she also testified that, she had no recollection of Tony tearing apart the booklet when he gave it to her. 158:6-9. Notably, the portions she produced to FINRA indicate that Ms. C actively read the materials since various portions are underlined and circled. 158:10-15. That brings us to the reliability of Ms. C's memory.

Ms. C's memory is simply not reliable and that is not my assessment of her memory – that is her assessment. Ms. C repeatedly acknowledged how unreliable her memory was. When FINRA asked Ms. C as part of the FINRA investigation if she recalled the forms and discussions she engaged in regarding her investment in CMOs, she readily tells FINRA that she did not recall. Read 124:9-125:1. Ms. C also testified that there were probably many conversations that she had when opening her account that she would not recall several years later. See testimony 125:2-8. You might ask yourself, how can any witness credibly assert that Mr. Turbeville did not discuss risks with her, and that she did not receive the disclosure guides, when she admits that she cannot recall many of the conversations surrounding her opening of the accounts?

Lastly, and what might qualify as some of the most absurd aspects of her testimony, Ms. C repeatedly asserted that she understood what Mr. Turbeville explained to her at the time he was explaining it but later has decided she did not really understand it. 133:7-14; 140:23-141:6. There is more of that nonsense to be found in the transcript at 69:8-10. Accordingly, when you go to weigh the evidence as it pertains to Ms. C, the evidence requires that you to disregard Ms. C's testimony as unreliable and disingenuous. The only evidence that can reasonably be relied upon is the opening account documents, the CMO disclosure documents that Ms. C edited and signed and the testimony by Mr. Turbeville.

⁵¹ Mr. and Mrs. R also have very significant credibility issues. To start, Mr. R originally testified that he did not recall meetings with any FINRA representatives. Why is this significant? Witnesses often assume that it is improper for them to meet with a prosecuting attorney so, if they are not prepared for the question, and are the type of witnesses that is inclined to lie under oath, they will often dissemble when asked this question. That is precisely what Mr. R did when he was asked this question.

Initially, he was astoundingly unable to recall meeting with FINRA except for one conversation "a few days ago" much to the apparent discomfort of FINRA staff asking the questions. (431:18-432:23). "Q: Have you met with representatives of FINRA before last night? A: Not directly, no." FINRA's Mr. Brown has testified that he spoke with Mr. R greater than five or six times "certainly" (1537) and that Mr. Brown and Ms. Whitaker met with Mr. R in May of 2011. 1538. FINRA met again with Mr. R immediately prior to the hearing date in June. Id. The very next day, after a good night's rest and presumably a conversation with FINRA, Mr. R's memory concerning his meeting with FINRA had improved dramatically and he was now able to respond to FINRA's questions on cue. Now he remembered when he was first contacted by FINRA (513:9-15), that he met with FINRA's Mr. Walker and Ms. Whitaker a few weeks earlier and that they came to his residence and spoke with him. 515:10-20.

When we questioned Mr. R about why he was altering his testimony on this issue, Ms. Hall interrupted our line of questioning and admonished me that we were mischaracterizing Mr. R's testimony from the day before. 530 With all due respect to Ms. Hall, her recollection was not borne out by the transcript. If you read the transcript for the prior day's testimony you will see that Mr. R was unable to remember ever having met anyone from FINRA until the night before he testified. The record also reflects that Mr. Walker repeatedly prompts Mr. R with the same question in an apparent effort to have Mr. R provide a truthful answer. He failed to provide a truthful answer. The next morning, Mr. R suddenly remembers his prior meetings with Mr. Walker. Now

perhaps one could believe that this is simply an indication of Mr. R's spotty memory. However, there are ample other reasons to question Mr. R's credibility as a witness.

Mr. R was an experienced businessman that had owned many businesses and particularly had a fondness for business that generated cash such as car washes and convenience stores. (425:4-9) (535:20-536:5, 534, 539-540 and 541). He was used to dealing with lawyers for his business deals and his various divorces. He was very familiar with using a power of attorney on his wife's behalf. 549-550. He learned about power of attorney from the title work that he had performed in times past. *Id.* In short, we have a very experienced and sophisticated businessman. Mrs. R was equally sophisticated. Ms. R testified that she was the head county health officer in charge of the entire county health department with approximately 70 full time employees and 20 part time employees. 663. She testified that all of the operations of the department reported up to her. 664. Clearly Ms. R possessed ample professional experience.

Mr. R testified that when he was a salesman involved in the mobile home business he would memorialize an agreement to sell a mobile home in writing. 535:20-536:5. He would review the contract with the customer, write out the purchase agreement and, rather than just give it to the customer, he would review it with them. Why? Because he wanted them to understand the agreement. *Id.*

Mr. R testified that he would not sign blank documentation with someone that he had never done business with and the more complex the paperwork the more time he would have spent reviewing it. 547. He even admitted that he would have been more conscientious of reviewing documentation for the first account he opened with Tony. He did not recall ever signing any blank documentation when he opened his first account with Tony. 548. Why did we get Mr. R to make these admissions? Two reasons: We wanted to establish that Mr. R, as a matter of habit, would have made certain that the information on first account forms that he executed for Tony Turbeville was accurate; and, because the information on the forms he initially completed for Tony contradict critical aspects of Mr. R's testimony and the declaration he provided to FINRA. These new account forms tell us that Mr. R's investment objectives were trading and speculation, his annual income was \$417,193, he had a net worth of three million dollars and that he certified that the information contained in the form was complete accurate and true. CX 30. This form is signed by clients with Mr. R signed on his wife's behalf utilizing his Power of Attorney. RX 52:1. Mr. R also completed the CMO disclosure form by initialing next to each disclosure and signing the completed form. RX 52:7. The paperwork is on its face methodically reviewed, initialed and/or signed and yet R's and FINRA think that it is credible to contend that the paperwork does not reflect information they provided or that they were unaware of the risks involved with regard to CMOs.

Once the trap had been sprung, Mr. R began to dissemble. Now, it was not his handwriting nor did he select those investment objectives (553:23-554:14) yet he admits that he understood the certification he signed to mean that all the boxes should have been filled in before he signed the document. 554:8-14. He further admits that his initials appear next each CMO disclosure (555:25-556:2) and that, had he read the disclosure concerning margin at the time he signed the documents, he would have understood what they meant. 558:21-25; CX 30:77. Mr. R now decides to assert that he is no longer sure if the document was completed or blank when he signed it. 554:2-14. However, FINRA's Mr. Brown testified that Mr. R never said that he had signed blank documentation. Had Mr. R done so, Mr. Brown would certainly have included that statement in Mr. R's declaration. 1551-1552; 648:14-20. There is no such statement in the R declaration. CX 32.

Let's move on to another piece of testimony by Mr. R. Tony Turbeville asked Mr. R and his wife M to provide an affidavit of support for Tony because a regulator was looking at how Tony was conducting his business. 519:1-7. Curiously, Mr. R testified that he executed the agreement but that the other signature on the affidavit did NOT belong to his wife. 568:17-569:9. This is shocking allegation intimating forgery and fraud on Tony Turbeville's behalf. Did Mr. R forget that he also testified that he and his wife went to Brookstone's offices together? 519:1-3; 572:8-11. Mr. R even went so far as to claim that he did not remember a notary being present when he signed the document. 568:24; 572:8-11. As you may recall, Ms. M testified that she specifically recalled Mr. and Mrs. R executing the Affidavit of Support. 3050:18-3058:19. Ms. M's testimony on this issue contradicts Mr. and Mrs. R's testimony concerning the execution of the affidavit. *Id.* See also Tony's testimony concerning the execution of the affidavit at 2042-2044. We thought it was quite telling that FINRA did not even bother to attempt to cross examine Ms. M. I suggest that this should be viewed by the Panel as a tacit admission by FINRA of the R's dishonesty on this issue.

So why would Mr. R intimate something that is so obviously untrue and inconsistent with his other testimony under oath? The good thing is that you do not need to guess as to why Mr. R would lie under oath. An oath to tell the truth means nothing to Mr. R. Just in case you think that is mere rhetorical flourish on our behalf, it is not. Mr. R has demonstrated that he is willing to lie under oath if and when he considered it to be in his best interest to do so.

Q: So what do you understand the sentence, "I swear that all of the information contained herein is accurate and true," that you'd lie if the circumstances were . . ."

A: Pardon?

Mr. Walker: Objection

Hearing Officer: Overruled.

Q: Did you understand that sentence to mean that it was okay to lie if Tony asked you to?

A: I felt that he was under pressure and he needed some – an affidavit signed by me giving his support.

Q: Was that the only reason you signed the affidavit?

A: Yes.

...

Q: Do you recall your earlier testimony that the reason you signed the document was because you had good bit of money with Tony and you wanted to stay on his favorable side?

A: That would be a correct statement.

Q: So your earlier statement a few minutes ago that the only reason you signed the affidavit was to assist Tony was not accurate, Correct?

A: No. It is a portion of both.

Q: Now it is a portion of both?

A: I felt that I was helping him and also helping myself by staying on his good side.

Q: and that made it all right to sign a sworn statement with untrue statements in it?

A: I did not know it was a sworn statement. There was nobody in the room but him and I and M.

Q: What do you understand the words "I swear" or the phrase "I swear" to mean? Do you consider that to be a sworn statement?

A: It's a play with words.

570:19-571:8; 571:21-572:15. As indicated above, Mr. R testified that he signed an Affidavit of Support that he knew was untrue, because he still had money at Brookstone and was concerned what his "friend" Tony might do to those funds if he did not sign the sworn affidavit. 519:16-19.

With regard to the affidavit of support, M R admitted that she requested changes to the original draft, the edits she requested were made and then she and her husband were left alone to discuss the final draft before they decided to sign it. 669-670; 657:1-4. Yet M R testified that she was uncomfortable signing the affidavit because it contained statements that were not true or accurate. 657:22-25. Then why did she sign the affidavit that she had edited? She, like her husband, says that she signed the affidavit that she believed was false because she still had money with Brookstone. 670. "Q: If you did not have money still at Brookstone, would you have felt free to say, "Sorry we're just not signing this?" A: Yes." 670: 25 – 671:2.

We do not believe that there is any credible reason to sign a statement, under oath, that you know to be false. Moreover, we think it would be improper for a panel to rely on the testimony of witnesses that freely admit that they are willing to perjure themselves. However, some less scrupulous people might think that excuse is a legitimate justification if it were true, but it is not true. The R wired out the last \$17,000 or so from their Brookstone accounts three days before they signed the affidavit. Presumably the R were quite aware that they were depleting the account with that last wire. Since the R do not hesitate to break an oath where money is involved, we should note that FINRA's Mr. Brown advised Mr. R that restitution was possible but not guaranteed. 1543. Perhaps that explains what motivates the R testimony. We should also note that Mr. Brown testified that the R never disclosed the existence of the affidavit of support to him in any of the many conversations that he had with them. 1547-1548. Once the existence of the affidavit became known to FINRA, the R never denied executing the affidavit or the authenticity of Ms. R signature on the affidavit. 1548. The customer declaration prepared by Mr. Brown based upon information provided by the R is misleading in several key respects. Paragraph 2 states that they attended a seminar in 2003 or 2004. Tony testified that it was

the end of 1999 or early 2000 and that they opened their first account with him in 2002. RX 52. Paragraph 5 fails to indicate Ms. R. substantial \$700,000 retirement account and does not list the R. multiple businesses. 2027-2028; CX42.

By the time we were permitted to cross-examine Ms. R. she seemed to have been prepared for many of the areas that we previously covered with her husband on his cross-examination and yet, when asked, she insisted that she did not discuss any of his testimony overnight or during the breaks. 666:13-25. Do you really think that it is credible that a husband that has just testified does not discuss any of his testimony with his wife that is going to testify the next day? Do you believe that? We leave that to your judgment. However, a review of the transcript may help you make up your mind. When Mrs. R. is pressed by me on whether she had discussed Mr. R. testimony, she changes her position. Suddenly, M. claims that she just discussed the things that Mr. Walker asked Mr. R. Id. This change in Ms. R. testimony goes to the issue of whether she is in any way credible.

Let's move on to another issue. On redirect Mr. R. tried to give the panel the impression that he and his wife were nearly destitute. He testified (under oath) "Well, we are spending what little savings we have put aside and – but it is going away quickly. We have no income at this – other than my social security and my wife gets a little money from her retirement pension, but nothing else. We try to conserve as much as – we do not spend money frivolously." 587:14-19.

Three sentences, one after another, right from Mr. R. lips, and each one of them is demonstrably untrue. Let's start with the last sentence first. "We try and conserve as much as – we do not spend money frivolously." He testified earlier that he had just come back from a two week trip to Hawaii. 436:6-9. If you have little money left, would you spend it on an extravagant vacation?

The second sentence, "We have no income . . ." he apparently forgot that he testified earlier that he still owns a car wash and even bought out his partner a few months ago. So he has income from the car wash and apparently had enough money to buy the business. 540-541.

"Were spending what little savings we have put aside." When Mr. R. closed his Brookstone accounts in ---- he had withdrawn over \$900,000 from the account. He also had a car wash business and Mrs. R. testified, reluctantly, that she had retirement funds of over \$700,000 (we will spend more time on Ms. R.'s testimony later). 665. This makes any claim to poverty appear incredible.

M. R. also tried to create the false impression that she had very little in the way of assets. She indicated that she had very little investment capital left and just a little stock that her parents had left her. She went as far as to testify on direct that they were just trying to live off social security. 661:18-25. You may recall that Ms. R. did not want to tell us the lump sum retirement package she received when she retired. When asked, she said, "is that relevant". Of course it is, particularly when you and your husband are trying to mislead a panel into thinking that you are damn near broke and have very little savings left. Ms. R. answer to the question: \$700,000. 665:5-10

Why would Mr. and Mrs. R. try and mislead the panel as to their financial circumstances? If your claims are legitimate, why lie about these sorts of things? Of course, the answer is obvious. An honest person with a legitimate claim would not attempt to repeatedly mislead the panel. We see no way that an objective panel can rely on the R. testimony for anything other than as another example of how FINRA failed to properly vet the evidence in this case.

If the R.'s are not credible witnesses, what should the Panel rely upon as a reasonable basis for assessing the investment activity in the R.'s account? We believe that the Panel should rely upon the testimony by Mr. Turbeville and the documentation executed by the R.

⁵² Mr. B. was another witness who was presented by FINRA although he was not competent to testify. Mr. B. did not appear at the hearing to testify and, as set forth in the footnote which follows, we have continuing objections to the entry of Mr. B. deposition as evidence in this case. You may recall that the date of the deposition was set unilaterally by FINRA without consulting the Respondents as to their availability. A few days before the scheduled deposition, FINRA unilaterally advised us that the deposition was no longer going to start at 10am but rather would now begin at 1pm. No explanation or reason was offered and there was no discussion as to whether that would be appropriate or fair to the Respondents. At the deposition, FINRA produced for the first time a whole raft of documentation that Respondents had no prior opportunity to review and so we were forced to read the extensive documentation, absorb the information contained therein, while the examination of the

witness was proceeding. Then, FINRA unilaterally ended the deposition even though both I and the witness, Mr. B■■■■, were willing to continue with his testimony. 1024-1026. What is even more disturbing is that Mr. B■■■■ testified that he was advised by Brooks Brown that, if he testified at the video deposition, he would not have to testify again. BT 55-56. The point of the deposition was to merely preserve the witnesses' testimony if he later became unavailable to testify in person. To tell the witness otherwise was misleading. Respondents brought these complaints to the attention of the Chair. The Chair ruled that it could not be used and that Mr. B■■■■ would have to testify. 1023:24-25. Ms. Hall subsequently changed her ruling with the understanding that Respondents would still have an opportunity to continue their cross examination of Mr. B■■■■ telephonically. 1025:8-20. Then, Mr. B■■■■ decides not to make himself available for cross examination but the video depo was permitted into evidence anyway. We believe it is manifestly unfair to admit testimony when the Respondents have been deprived of an adequate opportunity to cross examine the witnesses.

Mr. B■■■■' testimony was permitted into evidence even though it was quite clear from his testimony that he is no longer competent to testify accurately. Mr. B■■■■ testified that he sometimes no longer remembers his own name. B■■■■ Transcript 65. All transcript references in the section of the brief relating to Sam B■■■■ refer to the transcript of the B■■■■ video deposition and will bear the designation BT followed by page numbers. How in the world can we give any weight to the testimony of a man that acknowledges that he forgets his own name? That is not the only evidence that he was no longer competent. Mr. B■■■■ also acknowledged that his memory had declined in recent years. BT 102.

Mr. B■■■■ did not even remember all of his accounts including accounts that held over \$900,000 in annuities. BT 63:10-19. I suppose we could interpret the fact that Mr. B■■■■ forgot about an investment account with over \$900,000 of annuities as an effort by him to be untruthful about his extensive assets, but the fairer reading is that he was simply incompetent at the time of the video deposition. In fact, Mr. B■■■■ could not even recall the amount of capital that he had invested in annuities. BT 62:8-14.

Mr. B■■■■ had no recollection of preparing or signing the Declaration that Mr. Brown allegedly had him sign. CX49. He never recalled preparing a declaration with FINRA, reading the declaration or being asked to sign the declaration. BT 73:10. He did not even recall who FINRA was (BT 74:2-4) and went as far as saying he might have signed the declaration without ever having read it. BT 74:19-75:5. He, again, acknowledged the poor state of his memory. "I forget these things, you know." BT 75:7. Mr. B■■■■ could recall no telephonic conferences with anyone at FINRA. BT 57:2-8.

Mr. B■■■■ eyesight, at the time of his video deposition, was very poor. However, the deterioration of his eyesight and his physical decline was of very recent vintage. FINRA curiously did not explore this issue with Mr. B■■■■ on their direct examination. We do not know why. We can only presume that FINRA would never want to leave the panel viewing Mr. B■■■■' video deposition with the false impression that Mr. B■■■■ was unable to read the account documents that he executed or the correspondence that he received from Chris Kline. To leave the panel with that impression would be grossly misleading. Mr. B■■■■ testified that at the time he had his accounts with Chris, he could read pretty well, but he hit his head in January 2010 and had eye surgery and since then his sight declined significantly requiring him to use the special glasses that he was wearing during his video deposition. BT 57:25-59:8.

Mr. B■■■■' testimony is also unreliable on the issue of risk. He testified that if he had known that an investment with Chris had risk, he would not have invested in it. BT 67-68. However, this is inconsistent with the investments that Mr. B■■■■ made with representatives other than Mr. Kline.

Those investments, unlike the managed CMO portfolio, were high risk investments. For example, Mr. B■■■■ invested in high yield junk bonds :

- the Nuveen High Yield Municipal Bond Fund Class C—which included muni-junk bonds and muni bond Inverse Floaters. See RX 16:57 and the prospectus at RX79.
- The Dryden:Prudential Municipal High Income Class which invests in high income muni junk bonds. See RX 16:57 and the prospectus at RX77.
- John Hancock High Yield Muni Bond Fund Class C which included lower-rated fixed-income securities and junk bonds subject to greater credit quality risk and risk of default than higher-rated fixed-income securities. See RX 16:57 and the prospectus at RX76.

- Franklin High Yield Municipal Bond FD Class C which included "high yield" debt securities. See RX16:57 and the prospectus at RX78.
- Royal Bank of Scotland PLC 6.4% Non-cumulative Preferred Series M ADR. The S&P rating for this ADR was C. C is Standard & Poors second lowest rating- well below investment grade. See RX16:4 and the prospectus at RX80.

Mr. B. Raymond James accounts statements indicate that certain junk bond positions were transferred into Raymond James from another unknown brokerage account. We do not know what brokerage account those positions came in from or what other speculative positions were in those accounts. However, it is clear that Mr. B. purchased these high yield investments. He must not have been in command of his faculties at the deposition otherwise he would not have testified that he would never invest in a product that carried risk.

Given the loss of Mr. B. memory, what can we know about what Mr. B. knew concerning his account with Chris Kline? We know that when he completed opening account paperwork his vision was not impaired and he was in possession of his mental faculties. How do we know that he was in possession of his faculties? Because he took care to underline and make notes on the correspondence he received from Chris, even underlying various portions of the letters. For Example, see CX313:1; CX314:4. Chris provided Mr. B. with a report explaining the volatility of the CMO bond portfolio, losses in the portfolio and Chris' ongoing recommendations. CX 315. As further proof that the B. did not merely toss these letters in a box without reading them, portions of this letter are underlined. This indicates that he actively followed the progress of his account as is further evidence that by the calculations he made on exhibits CX311:3 and CX311:4.

Contrary to Mr. B.'s testimony, we know that Mr. B. was informed about the volatility in the portfolio due to interest rate increases because Mr. B. had those letters in the files he provided to FINRA. CX318:1. This letter discusses bond market volatility and Chris Kline's expectation that the market will continue to be challenging. Did Mr. B. read this document? He sure did. That he marked up the document is proof that he not only read the document, he actively read it.

For all of the foregoing reasons, the declaration provided by Mr. B. and his video testimony should not be given any weight and you should rely instead on the client's methodically completed account documentation and the testimony of Chris Kline.

We also note that the FINRA questionnaire submitted by Mr. and Mrs. B. does not appear to be in either of their handwriting. Mr. Kline disputes many of the allegations set forth in the questionnaire responses. Curiously, FINRA never asked Mr. B. about the questionnaire responses nor ever called Ms. B. to testify about the account or the Questionnaire. 2774:9-19.

Mr. Brown acknowledges that Mr. B. never advised him that Mr. B. was ever asked to sign blank documentation. 1606. FINRA tries to make the most of the argument that Mr. B. was asked to sign pre-filled account documentation. However, FINRA seems to be misleading the Panel. The pre-filled documents upon which FINRA relies (CX 314) were original documents in Mr. B.'s possession that he turned over to FINRA. There is no evidence that the documents were ever completed and signed by Mr. B. See Mr. Brown testimony at 1609 – 1610. Of course, this whole argument is rendered all the more ridiculous by the fact that FINRA acknowledges that it prepare customer declarations for the customers to review and sign. If it is acceptable for FINRA to engage in this type process, why is it not valid for a broker dealer to do the same?

⁵³ Let's turn our attention to a third declaration by Mr. D. Mr. Brown has testified that he prepared the declaration based upon information provided to him by Mr. D. That declaration was supposedly executed by Mr. D. (not sworn before a notary). The declaration prepared by Mr. Brown for Mr. D. (CX-60) contains the statement "I told him that my camping days were over and that I needed this money to provide income to supplement my pension in-house." Mr. Brown testified that this quote was something that he likely wrote into his notes is a "notable phrase". The same is claimed by the statement contained in paragraph 6 and 10 of the "Declaration". 1627. Curiously, FINRA has failed to produce the "notes" supporting these assertions. Mr. Brown claims that the statement contained in paragraph 10 of the declaration was reflected in one of the handwritten notes with Mr. D. sent to Mr. Brown. 1628 – 1629. We are unable to find any such statement in any of the materials provided by FINRA.

However, there is also an affidavit (sworn under oath and before a notary) prepared by Mr. D. with the assistance of Respondents' counsel Liam O'Brien and signed by Mr. D. on May 23, 2011. See RX 96.

The Affidavit contains statements that contradict those made in the declaration that Mr. Brown prepared .1630-1631. Mr. D... acknowledges that he met with Chris several times to discuss his financial objectives; that Chris reviewed the account paperwork and the CMO disclosures with Mr. D... in detail; that the paperwork accurately reflected his extensive investment experience and investment objectives; and that Chris answered any questions that he had before he executed the paperwork. RX96. The affidavit also includes what could only be described as truly disturbing allegations of misconduct by FINRA's investigator. Namely, the affidavit states that:

- FINRA bombarded Mr. D... with a steady stream of phone calls.
- Mr. D... did NOT assist Mr. Brown in the preparation of the "declaration".
- The declaration does not accurately reflect his investment experience, investment objectives, willingness to assume risk, nor his understanding of the products that he invested in.
- Mr. D... had no problem with the way his account was handled by Chris.
- Mr. D... believes that FIRNA is acting in an irresponsible and improper manner; and,
- Mr. D... believes that Chris Kline is being wrongly accused.

If Mr. D... is to be believed, it appears that he may have been pressured by an unscrupulous and aggressive investigator to make false allegations against Mr. Kline. Moreover, the D... affidavit includes assertions that are consistent with the information that Mr. D... provided in the account opening and disclosure documentation that were executed by Mr. D... for his managed CMO portfolio. RX96.

We suppose it is possible that the allegations of FINRA's misconduct by Mr. D... are untrue. Mr. D... may have taken advantage of the opportunity presented by FINRA's investigation. We can only speculate as to his motives. However, it should concern the Hearing Panel that FINRA's investigative process lacks sufficient safeguards to distinguish fact from mere opportunism by former customers. This would be less of a concern had Respondents been provided with access to the customers other brokerage accounts. Respondents repeated requests and motions for this information were opposed by FINRA and denied by the Hearing Officer. Had Respondents been provided access to the data requested, Respondents would not be at the mercy of either a poorly conducted investigation or an investigation that was being manipulated by the customers or both.

⁵⁴ Mr. J... G... is yet another witness presented by FINRA even though he is not competent to testify about the allegations set forth in the DOE complaint. Mr. G... never had an account with Brookstone and he was not involved in the management of his parents account. Mr. G... flatly testified that he was never involved in advising his parent in any way concerning their investments. 693:9-13. He was not familiar with any of the advisors that his parents ever used to manage their investments. 693:21-25. He was unfamiliar with his parents' prior brokerage accounts including their Legg Mason account and their SWS account. 749:1-5. He had no idea why his parents accountants received duplicate copies of his parents Brookstone account statement. 749. Were the accountants advising and guiding his parents? He has no idea. He did not assist his mother with any investment accounts or any investment account paperwork after his father died. 751:20-752:2. He never participated in any conversations between his parents and Chris Kline. 752. He had no idea what his mother annual income was, liquid net worth, investment experience. 710:21-711:2-10. He had no idea how much money his mother had been withdrawing from the account (707; 755) though he seemed to recall that his mother did withdraw about 260k of principal to purchase a new condo. 755. This is what Enforcement has tried to pass off as a fact testimony.

When Hearing Officer Hall questioned Mr. G... he immediately agreed that he did not make much of an effort to understand the trading strategy. 760. In light of that admission, it is revealing that Mr. G... opined that he did not understand why his mother was invested in CMOs as opposed to GE. 698. He testified that GE is a more conservative investment. GE is an interesting stock for him to have chosen as a bench mark because, as a matter of public record, GE lost 66% of its value – from \$33.63 to \$13.52 in the time period of January 2004 to September 2009. That is a 62% loss. Ms G... loss in her CMO investments was 26%. Furthermore, Mr. G... testified that he had no familiarity with fixed income products and never discussed the investments with anyone familiar with fixed income. 700.

Although Mr. G... was an experienced financial professional and received duplicate account statements for his mother's account even before the FINRA exam period, he made no effort to alter the managed CMO portfolio strategy. 1640-1641. More alarming, what did Mr. G... do with his mother's investment capital when he took over the investing? He engaged in a short term trading using a proprietary model. 705-706.

Perhaps the most interesting thing that Mr. G. did not know was the following: He had no idea that his very own sister, who had a background in finance (754), had actually assisted his mother with the opening of her Brookstone account. 753. FINRA has never told us why the son - who never had anything to do with his parent's Brookstone investments - was brought in to testify but the sister who helped the mother open the accounts was not presented for her testimony. The one with knowledge is conspicuously absent. The most likely explanation for why FINRA chose Mr. G. to testify is that Mr. G. retained counsel to pursue a claim against Chris Kline and Brookstone for the investment losses in his mother's account. Mr. Brown testified that he had told Mr. G. that there was the potential for restitution. 1639-1640. In other words, he had a motive to tell FINRA what it wanted to hear in order to bolster his claims against the Respondents.

Moreover, Mr. Brown's ignorance of the account is shocking. Ms. G. did not tell Mr. Brown that she had been sending duplicate account statements to her accountant Mr. Brown does not recall Ms. G. explaining why she did so. 1642-1643. Mr. Brown did not ask Ms. G. about the new account documentation that her daughter assisted her in completing. 1643. The G.s never advised Mr. Brown that they were pursuing litigation against Brookstone for losses in their CMO portfolio. Mr. Brown did not consider whether the information they were providing him would've been tainted by the fact that they were also pursuing litigation against Brookstone. 1645-1646. Mr. Brown did not even bother to compare the risk tolerance information allegedly provided to him by Mrs. G. with the risk tolerance indicated on the Raymond James or Merrill Lynch opening account documentation. 1646. Nor did he compare the liquid net worth information allegedly provided to him verbally by Ms. G. with the liquid net worth information set forth in the new account documentation from Merrill Lynch or Raymond James. 1646.

⁵⁵ We think that the first thing to note about Mr. R. P. is that there are no allegations in the DOE complaint with respect to any of Mr. R. P.'s accounts nor were any damages alleged in the complaint regarding R. P.'s account. Moreover, FINRA enforcement was required by order to identify all of the witnesses it intended to call prior to the commencement of the hearing and to describe their anticipated testimony and, while FINRA identified Mr. P. as a witness, they carefully stated that he was going to testify about "the investment recommendations made to his Mother, Carolyn P. by Respondents Brookstone and Kline". Did FINRA say that R. was going to testify about his account? No. but that did not stop FINRA from improperly eliciting testimony from R. about his understanding of his account with Brookstone.

Why is that wrong? That testimony is completely irrelevant to the allegations in the complaint and even more importantly was improper because the Respondents were given no notice of the allegations relating to Mr. R.'s P.'s account and no opportunity to prepare their defenses against those allegations. It is a basic procedural requirement that Respondents be given notice of the allegations that are being made against them and this basic requirement was utterly ignored by FINRA and quite frankly, improperly permitted by the Panel. This is trial by ambush. With all of the resources and manpower available to FINRA does it have to resort to these types of underhanded tactics? We would have hoped not but apparently we are wrong.

FINRA indicated in its pretrial disclosures that R. would testify about his mother's account. Mr. P. was not able to offer any substantial testimony about what was explained to his mother concerning the investments, what she understood about those investments and how those investments fit into her overall financial circumstances. The sad truth is that Mr. P.'s parents apparently did not rely on R. P. for anything substantial; they did not confide in R. P., they did not ask R. P.'s advice, and they did not trust him enough to even consult with him or confide in him concerning the ordinary type matters that parents discuss with their adult children. It is apparent from R.'s testimony that his parents had no confidence in his intelligence or abilities. R. P. never told Mr. Brown that he discussed the investments with his mother, or ever assisted her with her account paperwork. 1590 - 1591. The father did not trust R. to even let him help manage the father's equipment business and R. readily admitted he was not in any way involved in any of the finances of the business 372: 1-7. He testified that he did not know for certain if his father had life insurance or how much life insurance he may have had at the time of his death. 357:11-14. He testified that he had no substantive involvement in the handling of his father's estate. Carolyn P. handled the estate with the assistance of attorneys and she did not see fit to discuss any aspects of the estate matters with her son. 358:7-9. He testified that his mother handled the redraft of her trusts and wills with the attorneys. She did not entrust that

task to even though her husband had died. 367. He even testified he was not involved in the creation of the original trust when his father created it. In fact, said he did not even know about the trusts. 368:7.

When it comes to Carolyn P.'s account paperwork, readily admitted that he had no involvement in helping his mother complete any of the account paperwork. She did not seek his advice on any of the paperwork (381) and he was not present for any of the conversations his mother had with Chris or John K. and therefore would have no idea what transpired during those conversations. 382; 390-395. could not even tell us whether his mother reviewed her opening account documentation with John K. or with Chris Kline or both. 405:20-406:5. The same is true of all of the accounts his parents opened while his father was involved. had no involvement whatsoever in the opening or management of those accounts. 375-377. His father opened margin accounts at GunnAllen (377), though had no knowledge of these margin accounts despite his claim on direct testimony that his father was adverse to margin. It was Chris' understanding that the parents did not have any confidence in their children's ability to manage their investments. 2677-2678.

Mr. P. testified that he did not help FINRA draft the declaration for his mother and his mother never told him that that FINRA asked her for declaration 362-363. This is curious because FINRA's Mr. Brown claims that Ms. P. assisted him in the drafting of her draft declaration. He asserts that he had two or three conversations with Ms. P. before he even began drafting the declaration. 1584-1585. Ms. P. never executed the incomplete declaration because she was committed to an Alzheimer's home with dementia. This, of course, raises the question as to how much actual assistance, if any, she was able to provide to Mr. Brown. Mr. Brown did recall that Ms. P. recalled completing her account paperwork and that she did not tell him that she had ever signed any blank documentation. 1592:4-12. testified that he told FINRA he had his parents account paperwork for their previous brokerage accounts but that FINRA never bothered to ask him to send the materials 364 - 365. He even testified that he would have "eagerly" sent the materials if FINRA had asked for them. Id.

⁵⁶ Mr. P. is deceased and did not testify at the hearing. The only evidence presented in support of FINRA's allegations related to the P. account were the testimony of Mr. Brown, the declaration that Mr. Brown prepared for Mr. P. and some of Mr. P.'s account documents.

Mr. Brown discussed the declaration that he prepared for Mr. P. with Mr. P.'s attorney. 1659. However, he made no effort to determine if Mr. P.'s claims against Brookstone skewed the information the Mr. P. was providing to FINRA. 1660. Mr. Brown did not ask Mr. P. for documentation substantiating his income (1654) nor did he ask Mr. P. why his income was so small relative to his large liquid net worth. 1655. Mr. Brown did not compare any of the information allegedly provided by Mr. P. verbally to Mr. Brown with any of Mr. P.'s other account documentation. Id. Brown issued an 8210 request for documentation related to Mr. P.'s Salomon Brothers and Raymond James accounts. 1660. Mr. Brown recalls both requesting and receiving the new account documentation from Salomon Brothers and Raymond James. 1661. However, the new account documentation for Mr. P.'s Salomon Brothers and Raymond James accounts was never produced in discovery.

The Salomon Brothers account statements were produced and they offer information that directly contradicts the statements contained in the Declaration prepared by FINRA's Mr. Brown. For instance, the declaration at paragraph 3 claims that Mr. P. has limited investment experience yet it also admits that he opened accounts with Smith Barney in the mid-1990. As of 2001 (the earliest date for which we have account records) Salomon Brothers portfolio was worth over two million dollars. RX34-RX46. His portfolio was heavily weighted toward equities (approximately 75%). Id. For example, 35:14-17; 36:18-24; 37:15-20; 38:25-31; 41:31-46. In fact, P. had at least one Salomon Smith Barney brokerage account dedicated to speculative over-the-counter tech stocks. RX43. P.'s account statements indicate that he invested the vast portion of his Salomon Smith Barney portfolio in securities which generated very limited "income". For example, 35:1; 36:1 - 37:5. He also held fixed income positions in Treasuries, municipal bonds and some Fannie and FHR mortgage-backed securities. Id., for example 36:24-26; 39:76-77; 1662-1663. Mr. P. also admits in paragraph 12 of the declaration that he had long used margin at for his Smith Barney and understood that margin can magnify investment losses. This is clearly inconsistent regarding statements in the declaration regarding "not want[ing] to take much risk with this money at my age."

Respectfully submitted,



Liam O'Brien, Esq.
Francis Curran, Esq.
McCormick & O'Brien, LLP
9 East 40th Street, 4th Floor
New York, New York 10016
Tel. 212.286.4471
Fax. 212.504.9574

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
NATIONAL ADJUDICATORY COUNCIL**

Department of Enforcement,

Complainant,

v.

No. 20070011413501

Brookstone Securities (CRD No. 13366),
Antony Lee Turbeville (CRD No. 1721014),
Christopher Dean Kline (CRD No. 2597293) and
David William Locy (CRD No. 4682865)

Respondents.

APPELLANTS' APPEAL BRIEF

Alan M. Wolper, Esq.
Nathan W. Lamb, Esq.
Ulmer & Berne, LLP
500 W. Madison St., Ste. 3600
Chicago, Illinois 60661-4587
Email: awolper@ulmer.com
Email: nlamb@ulmer.com

James. D. Sallah, Esq.
Joshua A. Katz, Esq.
Sallah & Cox, LLC
2101 NW Corporate Blvd., Ste. 218
Boca Raton, Florida 33431
Email: ids@sallahcox.com
Email: jkatz@sallahcox.com

Attorneys for Appellants

Dated: October 12, 2012

TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	ARGUMENT	1
A.	The EHP Erred In Finding Fraud.....	1
1.	Oral and implied misrepresentations of risk are immaterial where there are written disclosures of the risk.	1
2.	The record includes no facts from which the EHP could reasonably conclude that Appellants acted with scienter.	4
B.	The EHP's Procedural Errors With Regard To The Scope Of Permissible Evidence Prevented Appellants From Obtaining A Full And Fair Hearing.....	5
1.	The limitation on the scope of evidence concerning suitability.	6
2.	The Hearing Officer prevented Appellants from obtaining presumptively discoverable evidence.....	7
3.	The EHP's refusal to permit argument concerning the sufficiency of DOE's evidence.	8
4.	Evidentiary rulings on the relevance of testimony concerning suitability.	9
5.	The findings concerning suitability failed to account for the information improperly excluded.....	9
6.	The Hearing Officer improperly excluded Appellants' expert witness.	10
C.	The Extended Hearing Panel Accepted Evidence Which Should Have Been Excluded.....	11
1.	SB's Deposition and the refusal to order the production of documents in DOE's possession.....	11
2.	The EHP permitted non-customers lacking personal knowledge to testify as to customers' investment objectives and financial goals.	12
3.	The EHP erroneously credited DOE's prepared declarations to substitute for evidence actually based on personal knowledge.....	14
4.	DOE's expert witness testimony, as well as the testimony of its examiner, should have been excluded.	15
D.	The EHP's Credibility Determinations Regarding The Customers Were Uniformly Wrong, And Were Contrary To "Substantial Evidence."	16
1.	Tony Turbeville's customers.	17
a.	Mr. and Mrs. R.....	17
b.	BC	19
c.	BB	21

TABLE OF CONENTS

2.	Chris Kline's customers.	22
a.	CP.....	22
b.	Mr. and Mrs. G	24
c.	HP	25
d.	SB.....	27
E.	If Liability For The Underlying Charges Is Not Found, Then The Supervision Charges Against Dave Locy, Which Are Entirely Derivative, Must Also Be Dismissed.	28
F.	Even If Liability Is Found, The Sanctions Meted Out By The EHP Were Punitive, Not Remedial, And Must Be Reduced Significantly.	29
III.	CONCLUSION	29

I. INTRODUCTION

The Decision by the Extended Hearing Panel ("EHP") should be reversed. It is rife with a multitude of errors of a material nature. Many of these errors alone mandate reversal, but, when viewed in the aggregate, that conclusion is inescapable. Accordingly, for the reasons outlined below, Appellants Brookstone Securities ("Brookstone"), Antony Turbeville, Christopher Kline and David Locy (collectively, "Appellants") respectfully request that the EHP's findings of liability be reversed.

II. ARGUMENT

A. The EHP Erred In Finding Fraud.

The EHP found that Appellants intentionally or recklessly misrepresented the CMO investments to the complaining customers as a "safe way, through government-backed bonds, to obtain a high rate of return on their investments. In reality, the CMOs . . . were high-risk investments whose returns were not assured, but instead, because of interest rate changes, were subject to dramatic changes in maturity, cash flow, and value." Decision at 41. The EHP concluded that Appellants misrepresented the "essential characteristics and risk[s] associated with the CMOs" and that these misrepresentations were material. *Id.*, pp. 44-45. The EHP also concluded that Appellants "acted intentionally or recklessly, and, therefore, with scienter, when they solicited their respective customers to purchase CMO securities and made misrepresentations and omitted facts in connection with those purchases." *Id.*, p. 46.

The Decision is erroneous: First, Appellants provided each customer with CMO Disclosure Forms, which the customers initialed and signed; as a matter of law, these purported misrepresentations are immaterial. Second, the EHP's conclusion that Appellants acted with scienter fails because the Decision identifies no facts which would lead to that conclusion.

1. Oral and implied misrepresentations of risk are immaterial where there are written disclosures of the risk.

The law is replete with authority holding that any implied oral representation as to the suitability of an investment is immaterial as a matter of law where the customer receives written disclosures contradicting the oral representation. Thus, information is only material if it "would have been viewed by

the reasonable investor as having significantly altered the 'total mix' of information available.'" *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

This is especially true, as here, when there are written risk disclosures provided to the customer. When written risk disclosures are readily available to investors, any contrary oral or implied representation as to "suitability" is immaterial. *See, e.g., In re: Westcap Enterprises*, 230 F.3d 717, 732-33 (5th Cir. 2000) (reversing district court and holding that, as a matter of law, a broker's representations as to the profitability of principal-only CMO and failure to inform that such bonds were unsuitable were not material when investor had available to him "the information necessary to appreciate the risks of the investment he was making"); *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1031 (4th Cir. 1997) (affirming summary judgment in favor of broker and finding general statements made as to suitability of CMOs would not provide basis for fraud claim when investor received specific risk disclosures); *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031-33 (2d Cir. 1993) (affirming summary judgment against group of 400 investors, concluding that even if the investments were unsuitable, when investors acknowledged receipt of written prospectus with risk disclosures, no Section 10(b) "unsuitability" claim could lie based on account executive's oral recommendations that the investment was "low risk" or "conservative").

Appellants provided written risk disclosures to the eight customers at issue, and these disclosures were made in a manner wholly consistent with NASD Notice to Members 93-73 ("NTM 93-73"). *See* CX-6 at 15; CX-19 at 5; CX-30 at 7; CX-33 at 11; RX-13 at 9; CX-58 at 7; CX-66 at 8; CX-104 at 7; CX-179 at 8. The following chart provides a comparison between what NTM 93-73's view of a member's obligation to customers when selling CMOs and the CMO Disclosure that each customer at issue here initialed and signed:

NASD NTM 93-73	Brookstone CMO Disclosure Form Signed and Initialed by Customers
<p>Although CMOs entitle investors to payments of principal and interest, they differ from CDs, corporate bonds, and Treasury securities in significant ways. CDs, corporate bonds, and Treasuries are issued with stated maturities and fixed interest rates." NTM 93-73, p. 1.</p>	<p>CMOs are not the same as conventional debt securities or CDs and the time to maturity may vary as well as the timing of principal returned. Brookstone Disclosure for Collateralized Mortgage Obligation (CMO) Securities, Item No. 2.</p>
<p>"[I]nvestors need to know that prepayment assumption—estimates based on historic prepayment rates for each particular type of mortgage loan under various economic conditions from various geographic areas—are factored into the offering price, yield, and market value of a CMO." NTM 93-73, p. 2.</p>	<p>The prepayment assumptions (estimates based on historic prepayment rates for each particular type of mortgage loan under various economic conditions from various geographic areas) are factored into the offering price, yield, and market value of a CMO. CMO bonds may pay off more principal than anticipated which may force me/us to reinvest at a lower interest rate. Brookstone Disclosure for Collateralized Mortgage Obligation (CMO) Securities, Item 3.</p>
<p>"Members should remind investors that, by selling their CMOs rather than waiting for the final principal payment, the securities may be worth more than their original face value." NTM 93-73, p. 2.</p>	<p>By selling CMOs rather than waiting for the final principal payment, the securities may be worth more or less than waiting for the final principal payment, and the securities may be worth more or less than their original face value. Brookstone Disclosure for Collateralized Mortgage Obligation (CMO) Securities, Item 4.</p>
<p>"[F]or securities purchased at a premium, the guarantee as to principal applies only to the par value of the security and not to any premium paid." NTM 93-97, p. 2.</p>	<p>For CMOs purchased at a premium, the guarantee as to principal applies only to the par value of the security and not to any premium paid. Brookstone Disclosure for Collateralized Mortgage Obligation (CMO) Securities, Item 5.</p>
<p>"IO investors should be mindful that if prepayment rates are high, they may actually receive less back than they initially invested." NTM 93-73, p. 2.</p>	<p>For Interest-Only CMOs purchased, if prepayment rates are high, then I may actually receive less cash back than initially invested. Brookstone Disclosure for Collateralized Mortgage Obligation (CMO) Securities, Item 6.</p>
<p>"[R]ising rates cause an IF's interest payments to drop dramatically. At worst, rising rates will lower interest payments and extend return of principal beyond the anticipated average life." NTM 93-97, p. 3.</p>	<p>For Inverse Floating Rate CMOs, rising rates will lower interest payments and extend return of principal beyond the anticipated average life. This may increase or decrease your effective yield. Brookstone Disclosure for Collateralized Mortgage Obligation (CMO) Securities, Item 7.</p>

As this chart illustrates, each customer was well aware of the risks and attributes associated with the CMOs that Appellants recommended.¹ Plus, Appellants also disclosed that “[t]he primary types of CMOs in my account will be ‘Inverse-Floating Rate’ and ‘Interest Only’ CMOs. In general, Inverse-Floating Rate CMOs increase in value when interest rates fall and decrease in value when interest rates rise.” See, e.g., CX-6 at 15. Appellants also provided customers “An Investor’s Guide to Collateralized Mortgage Obligations,” which was approved by the Bond Market Association. RX-72. This document is replete with information concerning CMOs, including those recommended by Appellants. *Id.*

Moreover, the Decision’s conclusion that Mr. Turbeville told two customers that they could expect 10 percent returns, or 15 percent if using margin, whether interest rates went up or down, is also contradicted by these written disclosures, as well as statements by these customers. Contrary to the treatment in the Decision, while Mr. Turbeville was confident he could achieve this type of return, he did not guarantee the return. See *In re: Westcap Enterprises, et al.*, 230 F.3d 717, 728 (5th Cir. 2000), citing *Raab v. General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) (“Projections of future performance not worded as guarantees are generally not actionable under the federal securities laws”). Additionally, the customers’ awareness that interest rates might move in either direction and knew these movements could have a negative impact on their return undercuts the materiality of any misrepresentation. *Id.* at 728 n.18 (“Some of the bankruptcy court’s conclusions, moreover, seem contrary to any conclusion that representations about the movement of interest rates could serve as a material misrepresentation. . . . A finding that [the investor] was aware that mortgage rates might move in either direction undercuts the materiality of any alleged misrepresentation”).

2. The record includes no facts from which the EHP could reasonably conclude that Appellants acted with scienter.

The EHP correctly recited case law defining scienter, “a mental state embracing intent to deceive, manipulate, or defraud” which includes severely reckless conduct, or “an extreme departure from the

¹ In one of the few moments when the EHP discussed CMO disclosures, the EHP wrote that Appellants failed to disclose the significant risks involved in CMO trading, as described in NTM 93-73. Decision at 51 (“Yet the Respondents failed to disclose the significant risks involved in CMO trading, as described in NTM 93-73”). As the chart, above, demonstrates, Appellants specifically did disclose the risks as they are described in NTM 93-73.

standards of ordinary care.” Decision at 45 (citations omitted). According to the Decision: “The evidence supports the conclusion that Brookstone, Turbeville, and Kline acted . . . with scienter, when they solicited their respective customers to purchase CMO securities and made misrepresentations and omitted facts in connection with those purchases.” *Id.* at 46. This description does not support any inference of scienter.

The EHP simply cites no facts to support its finding that Appellants’ misrepresentations and omissions were “intentionally misleading,” rather, it merely repeats DOE’s allegations that Appellants had made misrepresentations and omitted facts. See *Fogarazzo v. Lehman Bros., Inc.*, 341 F. Supp. 2d 274, 294 (S.D.N.Y. May 21, 2004).² There are no facts identified from which one could divine any mental state giving rise to either intentional or severely reckless conduct. Indeed, this void is fatal to a finding of scienter, and, thus, of securities fraud. The mere fact that one made a misrepresentation or omitted a material fact, in and of itself, is not fraudulent; thus, the material misstatement must be made with *with an intent to deceive*, not merely innocently or negligently. *Merck & Co., Inc. v. Reynolds*, 2010 U.S. LEXIS 3671, *12 (2010) (emphasis in original).

B. The EHP’s Procedural Errors With Regard To The Scope Of Permissible Evidence Prevented Appellants From Obtaining A Full And Fair Hearing.

The Hearing Officer (“HO”) and EHP unduly prejudiced Appellants by entering orders on evidence which are shocking. It is not merely that the EHP accepted speculative testimony, here or there, which should have been excluded; instead, the EHP demonstrated a pattern of unfairly restricting the Appellants’ ability to defend DOE’s charges.

First, even before the hearing began, the HO unfairly limited the scope of relevant evidence by refusing to order the issuance of 8210 requests for information concerning customer-witnesses’ prior investment experience and investment sophistication, including documents which are presumptively

² 341 F. Supp. 2d at 294 (“A statement is objectively misleading . . . simply by virtue of being false. For example, if someone says on Wednesday, ‘today is Monday,’ that statement is misleading. . . . But a statement does not become fraudulent simply by virtue of being false (or otherwise misleading)—the other elements of fraud, such as scienter and reliance, must also be present. In the earlier example, the statement ‘today is Monday’ is fraudulent only if the speaker’s statement was intentionally misleading because she knew what day it was (*i.e.*, the speaker acted with scienter) The point is that each of these are distinct elements of securities fraud and ought not be confused or combined”).

discoverable in customer arbitrations before FINRA Dispute Resolution. During the hearing, the EHP sustained this limitation by shutting down Appellants' opening statement and by limiting the scope of cross-examination, with the justification that this material was irrelevant. As the central allegation against Appellants concerned the suitability of Appellants' recommendations to these customers, the refusal to permit evidence which would contradict testimony unduly prejudiced Appellants.

Second, the EHP similarly accepted – and fully credited – testimony that, frankly, should have been excluded. For instance, as detailed below, the EHP allowed two customers' sons to testify on behalf of their parents, which prohibited Appellants from having the opportunity to confront the actual complaining witnesses. Apart from the obvious hearsay issue, the sons testified that they lacked knowledge concerning key information which would have been essential for providing evidence that the recommendations were unsuitable. Another witness also testified that he could not recall, for instance, signing a declaration prepared by the Staff. Finally, DOE obtained documents from one witness, yet refused to exchange those documents with Appellants, and the HO refused to order DOE to produce those documents. Ultimately, in connection with that decision, the HO told Appellants that if they did not like the outcome of this case, they could file an appeal.

As a result of this cumulative pattern of accepting tainted evidence against Appellants and refusing to permit Appellants from eliciting evidence in their favor, the EHP prevented Appellants from obtaining a full and fair hearing on the merits in this case.

1. The limitation on the scope of evidence concerning suitability.

The heart of DOE's charges against Appellants concerned the suitability of Appellants' recommendations to eight customers. The EHP properly recognized that such recommendations needed to be judged on the basis of "the investment objectives, experience, financial sophistication [and] retirement needs of the Brookstone customers." Decision at 13. Appellants attempted to obtain evidence prior to the hearing concerning these factors, namely, information from other financial institutions, but the HO refused to order DOE to issue 8210 requests for this information. Order Denying Motion to Order Enforcement to Issue 8210 Requests (Apr. 12, 2011); Order Denying Omnibus Motion *in Limine* (May

16, 2011). At the hearing, Appellants attempted to elicit testimony concerning this information, but the HO ruled, at times, that answers to Appellants' questions concerning this information would be irrelevant. *See, e.g.,* 544. As a result of these decisions, the EHP prevented Appellants from obtaining a fair hearing by restricting their opportunity to effectively cross examine witnesses.

2. **The Hearing Officer prevented Appellants from obtaining presumptively discoverable evidence.**

Rule 2310, which was in effect during the relevant time period, and which is at the heart of DOE's charges, provides that the suitability of a recommendation is based on the customer's other security holdings and his or her financial situation and needs, including the customer's financial status, tax status, investment objectives and other information considered as reasonable. *See* NASD Rule 2310(a) and (b). Because the customers' investment experience and sophistication was at issue, Appellants requested that the HO order DOE to issue requests pursuant to Rule 8210 to obtain documents concerning the investments held by the customers from firms other than Brookstone. For instance, the declaration of BC claimed she "kn[e]w very little about investments" and that another firm had "invested [her] money, but [she] knew nothing about the investments they recommended, other than the fact that [she] had lost money." CX-17 at 6. Similarly, the declaration of MR claimed MR had "very limited knowledge about investments" and that he and his wife were conservative investors. CX-32 at 1.

Even though these issues were directly material to the EHP's decision, the HO denied Appellants' 8210 requests in pre-hearing discovery as irrelevant. According to the HO, "information about a customer's trading activity at other broker-dealers is irrelevant. What matters is the suitability of the trade(s) at issue." Order Denying Motion to Order Enforcement to Issue 8210 Requests at 3 (Apr. 12, 2011), *citing Dept. of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7 at *53-54 (NAC Jul. 30, 2009). As the National Adjudicatory Council held in *Medeck*, in light of "the seriousness of the charges and possible sanctions," the Hearing Panel in this case erred in rejecting Appellants' Rule 9252 request for customer records.³

³ The HO's reliance on *Medeck* was incorrect, as the *Medeck* decision, reversing an extended hearing panel decision, explained why the 8210 requests in this case should have been ordered to be issued. While *Medeck*

The HO's determination that this information was "irrelevant" is contradicted by the determination of the NASD. Since 1999, the NASD and FINRA have determined that these documents are presumptively discoverable, and thus relevant, in customer disputes, based on indications from "forum users" that these are documents "they need to develop a case." FINRA Regulatory Notice 11-17, p. 1. If these documents are relevant before FINRA Dispute Resolution, where money alone is at stake, then these documents should be produced in FINRA disciplinary cases, where individuals' livelihoods are at stake – especially where, as here, the charges and possible sanctions include a lifetime bar from the securities industry and restitution in excess of \$1 million.

3. **The EHP's refusal to permit argument concerning the sufficiency of DOE's evidence.**

Consistent with prior orders denying Appellants access to exculpatory evidence, when the hearing commenced, the HO refused to allow Appellants to argue that they had been precluded from obtaining documents that would have demonstrated the customers' stated investment objections, risk tolerance at other brokerage firms. 27, 28, 31-32. Clearly, Appellants were entitled to seek and obtain documents, such as new account forms from other firms, which would have demonstrated that the account documentation at Brookstone was consistent with the forms at those other firms. It is the information contained in such documents that would reflect an unbiased and objective point of reference.

Notwithstanding the clear relevance of such information, the HO sustained DOE's objections, during opening statements, that this information was "irrelevant," based, as it was, on the HO's decision regarding the 8210 requests (and, presumably, the *Medeck* decision). This ruling was made regardless of its value for testing the veracity of statements made by the customer-witnesses at the hearing. In sustaining DOE's objection to Appellants' opening statement, the EHP claimed that Appellants were

focused on quantitative suitability, or excessive trading, as indicated by the HO, the NAC held that the 8210 request in that case should have been ordered to be issued, because such documents "also were relevant as impeachment tools." As in this case, the customer in *Medeck* answered "some questions during cross-examination [which] could be viewed as inconsistent with information contained in those records." The NAC decision also found that the motion for the 8210 request should have been granted, in part, due to "the seriousness of the charges and possible sanctions. . . ." Of course, in this case, the charges and possible sanctions are even more serious, as DOE requested (and the EHP ordered) Appellants Turbeville and Kline permanently barred and imposed sanctions in excess of \$1 million.

“going into – what you’re getting to is a sufficiency of FINRA’s evidence, and that’s something that you can address throughout the course” of the hearing and ruled that “[w]e’re not having any more of this because you’re really going far afield.” 31-32. Then again, Appellants had every right to argue to the EHP that “FINRA’s evidence” would be insufficient. Yet, the EHP told Appellants: “Close your opening argument, please.” 32.

4. **Evidentiary rulings on the relevance of testimony concerning suitability.**

Despite statements that Appellants would have an opportunity to cross examine witnesses concerning prior investment experience and sophistication, the EHP consistently sustained DOE’s objections to the introduction of such testimony. For instance, during the testimony of MR, Appellants inquired concerning MR’s investment objectives with his prior firm, Merrill Lynch. DOE objected, on the basis of time constraints and the fact that prior investment objections were irrelevant, and the EHP sustained the objection before Appellants could respond. 544. Even when Appellants pointed out that DOE had opened the door to this testimony on direct exam, the EHP would not reverse its prior ruling. *Id.* In another instance, Appellants objected to DOE’s examination of BC concerning her current investments at another broker-dealer, as no documentation had been produced to Appellants. 103. In this instance, the EHP overruled Appellants’ objection. *Id.*

When DOE asked JG’s son, for example, why his mother had updated her new account form to increase the priority of aggressive income, he testified “Why would she – Aggressive income to me; and I would imagine everyone in the room, aggressive is risk.” 717-18. Appellants objected to the response as speculative, but the EHP overruled the objection, where the response clearly was speculation and where the response was not based on personal knowledge. *Id.* In an analogous situation, when MR testified, on the basis of his personal knowledge, that information on his new account form was “[p]robably” accurate, the EHP sustained DOE’s objection based on speculation. 551.

5. **The findings concerning suitability failed to account for the information improperly excluded.**

Several witnesses testified that they (or their parents) held accounts at other firms prior to Brookstone. Based on the scant information that DOE provided, the EHP found that the complaining

customers “had very limited investment knowledge” (concerning MR); “very limited investment knowledge” (BC); “limited investment knowledge” (BB); “no understanding of investments” (CP); “very limited investment knowledge” (JG); “financially unsophisticated” (HP)⁴; and “limited investment knowledge” (SB). 21, 24, 27, 30, 33, 37. *See also* 14. As the veracity of this information was necessary for the claims submitted by DOE, Appellants were entitled to obtain documents with which to cross examine witnesses concerning these customers’ prior investment experience.

Appellants are entitled to the protections of due process, even though this case was tried before a hearing panel. In connection with discovery motions, the HO deprived Appellants of their due process rights and prevented them from obtaining a full and fair hearing.

6. The Hearing Officer improperly excluded Appellants’ expert witness.

The HO erred in denying testimony from Dennis P., Appellants’ expert, while permitting DOE’s expert, George F., to testify on some of the same issues for which Mr. P. would have testified on behalf of Appellants.

Appellants wanted to call Mr. P. on the issue of compliance regarding the purchase and sale of CMOs, including, among others, the adequacy of disclosures presented to customers, the suitability of CMOs for sale to elderly and/or retired customers, and assurance that customers understood the risks associated with CMOs. *See* Appellants’ Motion for Leave to Call Expert Witness, at FINRA 223 (Jul. 7, 2010). The HO denied Appellants’ motion because “Mr. P.’s expected testimony will be duplicative of the Hearing Panel’s expertise.” Order Granting and Denying Motions to Present Expert Testimony, at 2 (Aug. 12, 2010).

On the other hand, the HO permitted Mr. F. to testify at the hearing, and his testimony on the unsuitability of the recommendations and inadequacy of client disclosures was adopted by the EHP. *See* Decision at 14 (“F. found that the Appellants’ disclosure documents did not adequately disclose these

⁴ HP passed away prior to the hearing. As stated in the Decision, the basis for finding that HP was “financially unsophisticated” was testimony by Mr. Brown concerning his conclusions and observations of HP when he interviewed HP. 36-37.

risks to their CMO customers”)⁵; *id.* at 43 (“Appellants did not disclose the characteristics and various risks associated with the different CMO payment structures and interest rate sensitivity”).

C. The Extended Hearing Panel Accepted Evidence Which Should Have Been Excluded.

Besides the failure to allow admissible evidence, the EHP also improperly admitted evidence into the record which should have been excluded.

1. SB’s Deposition and the refusal to order the production of documents in DOE’s possession.

The EHP should have excluded the deposition testimony of SB, who appeared at a pre-hearing deposition in lieu of appearing at the final hearing. The deposition was scheduled to begin at 10 a.m.⁶ 1024. When SB appeared, he and his wife provided documents to DOE. 1065-66. DOE delayed the commencement of the deposition until 1 p.m., in order to allow DOE to review the production and prepare for the deposition. 1024.

As a direct result of DOE’s delaying the commencement of the deposition until 1 p.m., Appellants were prevented from completing their cross-examination of SB, as noted in the Decision. Decision at 40. Appellants requested that the deposition be renoticed to allow the continuation of SB’s cross examination. The EHP stated that SB should be “available on-the phone for cross examination.” 1024-25. However, the deposition was not renoticed, and SB was not available on the phone for cross examination. Regardless, the Decision erroneously concluded that “[a]lthough his cross-examination was not completed, the Hearing Panel found that the two-plus hours of cross-examination was approximately equal to the direct examination conducted by Enforcement, and provided Appellants a fair opportunity to test SB’s version of events.” Decision at 40.

Second, DOE did not provide copies of these documents to Appellants. After the deposition began, DOE used some – but not all – of the documents received that morning. Transcript of Deposition

⁵ With regard to one of the disclosures, ~~Feng~~ also testified that he was unfamiliar with the Bond Market Association booklet regarding the risks associated with CMOs, a booklet which the customers acknowledged having received. 938.

⁶ Curiously, DOE changed the time to 1 a.m. and arranged to meet with SB and his wife in the morning, when SB and his wife provided documents to DOE to review.

of SB at FINRA 003318-19 (May 3, 2011). DOE did not make copies for Appellants to review. *Id.* at 003335; 1086. Instead, as exhibits were presented to the witness, DOE would show a copy to Appellants and then give the copy to the witness. *Id.* DOE never showed Appellants any of the documents that DOE chose not to show the witness. SB Trans. at FINRA 003319; 1086. DOE claimed that, even though it had reviewed these additional documents not introduced at the deposition, these were “other documents that we looked at and declined to take possession of.” SB Trans. at FINRA 003319. Appellants requested that the HO order DOE to produce all of these documents, but the HO refused: “We have in front of us the documents we have. I don’t think FINRA is obligated to go further and look for more documents that are outside of its possession I’m not going to order them to do anymore. This is just one of those issues and I know there are probably many from your point of view, but if you don’t like the outcome of this case, take it up on appeal.” 1086-87.

Third, it was clear from the record that SB was not competent to testify. During the deposition, SB’s wife sat next to him and prompted him with answers to questions, which the HO acknowledged. 1046. SB’s wife was never sworn in by the HO, and Appellants never had an opportunity to cross-examine her. Yet, DOE knew when taking SB’s testimony that SB’s wife should have been excluded from attending the deposition, but stated on the record that SB “needed her there for moral support” and that her assistance was “tantamount to refreshing [his] recollection.” 1046-47.

Despite these improprieties, the Decision nevertheless accepted SB’s testimony and Declaration as “credible and reliable.” Decision at 40. However, SB’s testimony and Declaration should have been excluded from evidence based on his lack of competence to testify (including the fact that SB could not remember the Declaration from 2008, which the Decision credited), DOE’s withholding of evidence from Appellants, and the lack of opportunity provided to Appellants to cross examine SB.

2. **The EHP permitted non-customers lacking personal knowledge to testify as to customers’ investment objectives and financial goals.**

Two customers (JG and CP) did not testify at the hearing, yet the EHP accepted evidence concerning them, principally through the testimony of their respective sons, as well as Mr. Brown, to fill

in the gaps. Besides the hearsay issue, this testimony should have been excluded because the witnesses who did testify lacked personal knowledge regarding critical issues concerning the customers' investment experience and sophistication.

JG's son, for example, lacked personal knowledge. He testified that he had no idea if the investment objectives on one new account form were correct and specifically conceded that he did not know his mother's investment experience. 710-11. When asked about his mother's investment or financial knowledge, he admitted he had "very little knowledge." 723. He was aware his parents held other accounts, but knew them only by name. 748. His mother had suffered a stroke in October 2007, but he had no idea whether his mother had been diagnosed or examined for dementia or loss of memory following her stroke. He did state that she had moments of forgetting things. 757, 750-51.

There was another impropriety regarding the testimony of JG's son. Appellants requested that DOE issue an 8210 request for JG's son to appear, but DOE would not, claiming that the request was after the deadline and was unnecessary, as he and his mother would be testifying voluntarily. 7766-67. JG, however, decided not to testify. 758. When DOE learned of her decision, after the commencement of the hearing, DOE then issued an 8210 request for JG's son, who is a person associated with a member, to testify in her place. 691-92. The 8210 request was issued to JG's son even though it came long after the deadline for issuing such requests. 756. The EHP permitted the testimony because "Appellants got what they wanted and [JG's son] was here, you were able to have him testify. . . . I think these were extraordinary circumstances and I can understand why [DOE] issued the 8210 request. . . . I'm going to rule that there's no prejudice to the Appellants." 767-68. Appellants stated on the record that they were not told that JG's son would be testifying, and objected to the tactic of shielding the actual accountholder from cross-examination by using relatives. 768.

The same tactic was used for CP. CP's son testified for his mother, who had dementia. Decision at 33. Like JG's son, CP's son lacked knowledge about his parents' income during the relevant time period. 271. However, more egregiously, the EHP permitted CP's son to testify not only about what he believed his parents' expectations and investment objectives might have been, but in connection with his

own accounts. *See* Decision at 33; 259-264. Appellants objected to this testimony because it was irrelevant and they had never been afforded the opportunity to conduct discovery with regard to CP's son. 259, 261. The EHP decided: "He's here. You can cross-examine him by asking him questions here." 266. Of course, Appellants' cross-examination could not be based on discovery that was deprived them as a result of this ambush tactic. CP's son was never even listed as a witness by DOE. Nevertheless, the EHP permitted DOE to continue its examination of CP's son. 266.

3. **The EHP erroneously credited DOE's prepared declarations to substitute for evidence actually based on personal knowledge.**

While hearsay can be admissible in this forum, reliance on hearsay as the basis for a finding can be dangerous. It is incumbent on the HO to ensure that the parties still have a fundamentally fair hearing. Allowing a party opponent to testify on behalf of a non-present witness, regardless of the reason for why they could not appear, is fundamentally unfair, as it deprives the opposing party of the ability to cross-examine the absent witness.

The EHP permitted evidence concerning two complaining customers, BB and HP, entirely, or almost entirely, through declarations the Staff prepared and through the Staff's testimony that the declarations they prepared were accurate at the time they were prepared. Decision 28-29; 36-37. Appellants could not cross-examine the complaining customers at all, and Appellants (as well as the EHP) were required to rely entirely on the veracity of the Staff's testimony, biased as it was, on how the customers would have testified. This was not fundamentally fair.

Moreover, on the issues of investment experience and sophistication, Mr. Brown testified that he had not inquired into these areas beyond the purported statements made by the customers. *See* 1564-65. He also testified that he had not inquired into the competence of witnesses, even though the purpose of the declarations was supposedly because "[t]here was fear on my part and my management that if we didn't take some step to memorialize what they were telling us at the time, that down the road their memory could be impaired." 1575,1581-82; 1130-1131.

Nevertheless, the EHP credited the declarations of complaining customers, like BB and HP, because their declarations were “corroborated in so many respects by Turbeville’s other customers, and with testimony and declarations about how Brookstone’s other CMO customers were treated” and as “consistent with the testimony and Declarations of the other customers.” Decision at 29, 37. Yet, this reasoning is flawed, and demonstrates a disregard for the fundamental fairness to which Appellants were entitled. Notwithstanding Appellants’ testimony that contradicted the testimony of the customers, the EHP credited all of the declarations as consistent with the testimony of “witnesses,” even though these witnesses included sons testifying for parents, a FINRA Staff member testifying for a deceased customer, customers whose testimony included internal inconsistencies and one witness who could not even remember reviewing or signing his declaration. Otherwise, the EHP depended on the orchestrations of the FINRA Staff, which had a vested interest in this case and which failed to inquire into anything which would contradict what the customers purportedly told the Staff.

4. **DOE’s expert witness testimony, as well as the testimony of its examiner, should have been excluded.**

DOE called as its expert witness Gifford Fong. Because Mr. Fong’s report and testimony were based on the same faulty premises which should have resulted in the exclusion of the testimony concerning the customers, Mr. Fong’s testimony should also be excluded.

Mr. Fong’s testimony concerning the risks involved in investing in CMOs, as well as the suitability of these investments, was derived by disregarding the new account forms and risk disclosures which the customers signed and/or initialed and by assuming, instead, that the investors’ investment objective was capital preservation, based on the faulty declarations which FINRA prepared. 989. He also never familiarized himself with any of the disclosures, including the CMO Risk Disclosure booklet, which the customers acknowledged having received. 937-38. Instead, he concluded that he would not need to see the disclosures to determine, for instance, that MR could not understand CMOs. 938.

D. The EHP's Credibility Determinations Regarding The Customers Were Uniformly Wrong, And Were Contrary To "Substantial Evidence."

Appellants concede, as they must, that to urge the NAC to overturn the decision of the EHP because the EHP's conclusions regarding the witnesses' credibility were uniformly and fundamentally flawed is a difficult approach to take. This concession stems from the longstanding proposition that a hearing panel's assessment of witness credibility "is entitled to considerable weight and can be overcome only where the record contains 'substantial evidence' for not doing so." *DOE v. Pacific On-Line Trading & Securities, Inc.*, Complaint No. C01000037 (Nov. 12, 2002) at 10, quoting *Anthony Tricarico*, 51 S.E.C 457, 460 (1993). With that said, it remains that faulty credibility decisions – materially and serially faulty – can indeed constitute such a plain error that reversal is mandated. That is the case here.

At literally every available opportunity, the EHP concluded that Appellants and their witnesses were not credible, while finding that witnesses propounded by DOE were, without exception, credible. To reach these conclusions, the EHP necessarily had to ignore a massive amount of contrary evidence, evidence that, viewed in the aggregate, easily exceeds the "substantial" benchmark cited above.

DOE based its allegations on trades made in the accounts of eight customers. Of those eight, the EHP dismissed all charges relating to one, LD, based on the fact that after signing a Declaration drafted by a FINRA examiner, LD subsequently signed an Affidavit effectively rescinding the statements contained in his prior Declaration. More on this later. That left seven customers (or, more accurately, seven groups of customers, as some were actually husband and wife). Indicative of its failure to acknowledge the evidence highlighting differences among the customer witnesses, the EHP blithely – and by that we mean without reference to the record – found that "all" of them: (1) were "unsophisticated investors who had always relied on brokers to assist them with their investment needs" (Decision at 19); (2) were "looking for safer alternatives to equity investments" (Decision at 19); and, (3) were "led to believe that CMOs were safe, government-backed instruments for their retirement funds. (Decision at 20) In fact, even a casual review of the record would reveal vast differences among the customers.

1. Tony Turbeville's customers.

DOE called three of Mr. Turbeville's customers to testify regarding their investments: Mr. and Mrs. R (who we are counting as one, inasmuch as they testified about the same accounts), BC, and BB. As noted above, the EHP found each to be credible. On the flip side, the EHP found Mr. Turbeville not to be credible. The record is clear that the EHP erred in reaching this conclusion, and erred dramatically.

a. Mr. and Mrs. R

The EHP concluded that Mr. R – with an acknowledged net worth of \$3 million (550-551) – was unsophisticated.⁷ While that is convenient for the EHP, since it is a necessary finding to support the overarching conclusions that DOE met its burden of proof, it ignores Mr. R's undeniable business acumen: he owned two car washes (in fact, it seems he still owns one), a mobile home dealership, a mobile home park, two convenience stores and a rental property. 425-426. It also ignores the fact that he had an account with Merrill Lynch containing over \$1 million in stocks and municipal bonds.⁸ 449-450. Does that alone make him sophisticated? Not necessarily, but it does demonstrate that the EHP completely ignored the existence of the stocks: in listing the types of investments that Mr. R had made before meeting Appellants, which, according to the EHP, serve to reveal Mr. R's supposedly "very limited investment knowledge . . . and experience," the Decision totally omits any mention of his substantial equity portfolio. Decision at 21. Even more egregiously, the EHP also found that prior to meeting Mr. Turbeville, Mr. R "had never . . . purchased investments on margin." *Id.* To the contrary, Mr. R readily admitted that he had "invested on margin before." 459. Granted, investing on margin alone

⁷ Presumably the EHP also found that Mrs. R was similarly unsophisticated, notwithstanding the fact that she had her Master's degree (596), and characterized her own knowledge of financial products and investments as "average," not below average, not minimal. 597.

⁸ Perhaps not surprisingly, the Staff never deigned to ask Mr. R about his Merrill Lynch accounts (532), since his answers to such questions would undoubtedly have undercut their claim that he was inexperienced and unsophisticated. This omission in the investigation did not merit any mention in the Decision, for whatever reason.

may not make one sophisticated, but, when coupled with the other errors the EHP made, it is evident that the conclusion he lacked sophistication is unfounded.⁹

There are a host of other issues with Mr. R's testimony, and the EHP's utter reliance on anything he said. First, he testified that he did not need income (479-480), and, consistent with that statement, that his signed new account forms – which reflect an investment objective of aggressive income – were inaccurate. Yet, contrary to these assertions, Mr. R admitted that Mr. Turbeville's strategy was attractive to him because it could potentially return 10%, which was more than the 6% his municipal bonds were paying. 454. Municipal bonds are a straight income play. Moreover, such testimony is contrary to the EHP's finding that Mr. R, like "all" the other customers, was "looking for safer alternatives to equity investments." Decision at 19. Mr. R said no such thing.

Mr. R insisted that Mr. Turbeville promised him 10%, 15% if margin was utilized. Yet, Mr. R also acknowledged that there was no guarantee of such, and, in fact, this was disclosed to him in writing. 453. Interestingly, Mr. R conceded that he saw losses in his account for four to five years before he eventually moved his money out. 510. Under anyone's definition, four to five years of losses cannot possibly be consistent with any supposed guarantee.

Finally, the biggest problem with Mr. R's testimony, and, in turn, the EHP's unwavering reliance on it, comes in the form of an Affidavit (RX-102) that he and his wife signed. The Affidavit served, in essence, to recant and contradict many of the statements Mr. R had made in his earlier sworn Declaration.¹⁰ One other customer, LD, completed a similar Affidavit sometime after he signed his Staff-prepared Declaration. CX-326. For some unarticulated reason, however, the EHP treated the two affidavits in completely different fashions. The fact that LD's Affidavit contradicted his prior Declaration led the EHP to dismiss all charges against the Appellants that were related to LD "for lack of evidence."

⁹ It is also notable that Mr. R's testimony at the hearing that he had previously utilized margin in his investment accounts flatly contradicts his Declaration, in which he unequivocally denies any prior use of margin. CX-32. This would seem to shed more than a bit of doubt on the credibility of that Declaration, as well as the EHP's conclusion that Mr. R "stood by his sworn declaration of events." Decision at 24.

¹⁰ Strangely, Mr. R testified that he authored the Declaration and that his wife typed it up. 517. That was not at all true. It was prepared by FINRA Staff, like all the other Declarations that were admitted into the record.

Decision at 40. Mr. R's Affidavit, on the other hand, not only failed to result in a similar dismissal of charges, it was not even mentioned in the Decision. How can there be such a disparate treatment of two documents, both having the same import?¹¹

Regardless, it is undisputed that Mr. and Mrs. R both testified that they signed an Affidavit, under oath, that they maintained contained numerous false statements. Despite this, the EHP not only found them to be entirely credible, but it failed even to address these witnesses' apparent willingness to lie under oath when convenient for them. In short, Mr. and Mrs. R's entire testimony, which the EHP adopted wholesale, was clearly belied by "substantial evidence" to the contrary, and which supports the conclusion that the EHP erred in its credibility determination.

b. BC

Similar issues abound regarding the EHP's conclusions regarding customer BC. As with the Rs, the EHP's threshold conclusion that she was "looking for safer alternatives to equity investments" is incorrect. According to BC, she moved her money to Appellants from an account at Wachovia because she "had been losing money continuously the whole time." 45; 170. Strangely, she testified that she did not know what she had invested in at Wachovia, including whether it was in stocks or bonds. 46. Thus, unless the EHP is clairvoyant, its finding that she was moving from equities is unfounded, since it could not have known the nature of her Wachovia investments.¹²

¹¹ There is another thing to bear in mind regarding the Rs' Affidavit. The Rs testified that they signed it "under duress," because they still had money invested with Appellants, and were afraid that if they did not sign it, their positions would be liquidated for further losses. 526; 572; 657; 660. There are three problems with this testimony. First, Mr. R admitted that he insisted that certain changes be made to the Affidavit before he signed it, and that Mr. Turbeville readily agreed to make them. 581-82. Mrs. R said the same thing when she testified. 656-657; 660; 669; 672. Second, the record reflects that at the time Mr. R signed the affidavit, he had *already* moved his money away from Appellants. 2059-2060. RX-116 and RX-117. Given that, his claimed fear of loss makes no sense. Finally, in February 2007, three months prior to signing the Affidavit in May 2007, Mr. R signed two "CMO Account Liquidation Forms" (CX-367) that removed *all* discretionary power from Mr. Turbeville over the two CMO accounts. As a result, Mr. Turbeville could not buy and/or sell anything without first obtaining Mr. R's express permission. Given these last two undisputed facts, the Rs' claimed fear of loss makes no sense.

¹² In her Declaration (CX-17, pp. 6-8), signed in 2007, BC was similarly unable to identify the nature of her prior investments. That did not give the EHP any pause, however. As far as it was concerned, the Declaration was still somehow credible.

More troubling is the fact that the EHP found that Mr. Turbeville “did not disclose any risks associated with his recommended investment strategy” (Decision at 25), even though the record plainly reveals otherwise. BC testified repeatedly that she was well aware there was no guarantee. 40; 41; 77; 163. Right above her signature on the Customer Risk Assessment that she signed in May 2006, in all caps and bold letters, BC acknowledged her understanding that “[T]HE INVESMENT WORK THAT YOU [Appellants] PERFORM FOR ME COMES WITHOUT GUARANTEES REGARDING INVESTMENT PERFORMANCE.” CX-6, p. 14. Even more telling, BC flat out admitted to the EHP that she understood “that there was a risk of substantial losses for [her] CMO investments.” 153. Later, while she denied a willingness to accept “high risk,” she again acknowledged that she “was under the impression that there is always risk involved.” 198. Such admissions are hardly surprising, however, given her testimony that before she signed¹³ the Account Owner’s Statement of Understanding/Obligation, and initialed each of the disclosures on that form, Mr. Turbeville read to her each one.¹⁴ 69; CX-6, p. 11. Of course, one of those disclosures expressly state that she could incur “substantial losses” if she liquidates during an inverted yield curve. The EHP conveniently ignored this documentary evidence and all this testimony.¹⁵

In any event, even without considering the testimony of Mr. Turbeville, who adamantly insisted that he always disclosed risks to his customers, that is, even if we focus only on BC’s testimony, the record still does not support the EHP’s finding that no risks were disclosed to her. Again, the EHP ignored “substantial evidence” refuting its credibility determinations. And because those determinations serve as the basis for the entire ruling, the ruling is flawed, and should be reversed.

¹³ It is significant that BC actually made handwritten changes to one of the disclosures on this form before signing and initialing it. CX-6, p. 11. Indeed, in her Declaration, she states that she “demanded that [Mr. Turbeville] remove that language.” CX-17, p. 7, § 12. Given this, she cannot credibly claim that she signed her account documents without reading or understanding them.

¹⁴ That BC was well aware there were risks associated with her investments is also established by her admission that she knew full well as early as 2006 her account was losing money. 83.

¹⁵ Characteristic of the EHP’s “cherry-picking” of the evidence to support its conclusions, it makes no mention of the CMO disclosure booklet in the discussion in the Decision about BC. A panel is free to make credibility calls; it is not free, however, as the EHP did here, simply to ignore unrefuted, documentary evidence just because it does not fit the panel’s theory of the case.

There is another significant problem with the EHP's analysis of BC's investments. It is undisputed that in June 2004, she signed new account documentation reflecting a primary investment objective of aggressive income. 189; CX-14, p. 6. In May 2006, she signed another form reflecting the exact same investment objective. 189; CX-6, p. 9. For some unstated reason, however, in discussing what it somehow divined to be BC's true investment objective, the EHP ignored both of these signed documents and, instead, focused entirely on an *unsigned, uninitialed, undated* form from February 2006 that BC apparently had in her records, but which Appellants curiously did not, which reflected a more conservative investment objective. CX-14, p. 10. The timeline is important here. BC claimed she made these changes in February 2006 because the information on the form, including the aggressive income investment objective, was, in her view, not accurate. 183. Yet, a mere three months later, she signed a form that contained the same, supposedly incorrect information.¹⁶ In fact, she not only signed the May 2006 form, she actually handwrote certain changes to it. 51-52; CS-6, pp. 8-9. Notably, however, these changes did *not* include the stated "aggressive income" investment objective. Once again, the EHP elected simply to ignore these undisputed facts.

c. BB

BB appeared and testified at the hearing, but, as the EHP found, "her memory of events was foggy and confused, and she was unable to provide any meaningful testimony." Decision at 28-29. Undaunted by this, the EHP relied instead on the sworn Declaration that she signed back in 2008 in making its findings. CX-23. BB candidly admitted, when confronted with that Declaration, that she did not know why she sent it to FINRA. 228. She also told the EHP that while her memory of events was better in 2008 than it was at the hearing, she could not say how much better it was. 232. This did not serve to dissuade the EHP from relying on the Declaration.

In a remarkable display of bootstrapping, the EHP concluded that her Declaration was "reliable" because it "was corroborated in so many respects by Turbeville's other customers, and with testimony and

¹⁶ When asked why she did this, BB testified that when she signed the form in May, she "had forgotten" the changes she purportedly made three months earlier. 184.

declarations about how Brookstone's other CMO customers were treated." Decision at 29. In other words, the EHP found BB's Declaration to be reliable solely because it was consistent with testimony from other customers. But, if those other customers are proven to be unreliable, then, in turn, BB is similarly unreliable. FINRA has recognized the problems with customer Declarations that contain statements that are later contradicted, or are otherwise inconsistent with the evidence adduced at the hearing. DOE v. Katsock, Disc. Proc. No. C9A020018 (Sept. 4, 2003) at 27 n. 13 (customer declaration that is inconsistent with information on account forms, and which contains unexplained contradictions with other evidence, is entitled to no more weight than respondent's testimony). In light of the incredible amount of contradictory evidence that the EHP appears to have deliberately overlooked in an effort to support its conclusions, all the customer Declarations in this case, but particularly BB's, are of very dubious value.

2. Chris Kline's customers.

a. CP

Unlike Mr. Turbeville's customers, CP, who apparently has Alzheimer's, did not appear and testify. 24. Moreover, she never even signed a Declaration. So, how did the Staff attempt to prove its case as it related to CP's investments? They had her son, R, testify. The problem is, R did not know anything about his mother's account. Although he was present at the first meeting his parents had with Mr. Kline, he recalled exactly none of the particulars or details (251-252; 335); indeed, he had no idea if investment recommendations were even made at the time. 255. He did not know when his parents first opened their account with Mr. Kline.¹⁷ 256. He did not know if his father had any experience trading bonds.¹⁸ 256; 274. He did not know how much money they had. 256. He did not know what

¹⁷ As with other customers, the EHP also erred when it found that CP moved her account to Appellants to find "safer alternatives to equity investments." In fact, it is undisputed that her late husband elected to move the account because he felt Merrill Lynch was churning the account and using too much margin. 253-255; 334.

¹⁸ The EHP concluded that R's father "had some investment knowledge." Decision at 30. In fact, R testified repeatedly that his father was a savvy investor, in many different ways. His father "was pretty knowledgeable on the stock end of it." 256. He set up numerous trusts for his children's and grandchildren's education and medical needs. 273; 368. "He was the one who took care of it all." 275. R readily admitted that his father "knew more than [R] would ever know." 368. That is completely consistent with Mr. Kline's testimony that R's father

kind of investments they had in their account. He only learned that it included inverse floaters after the accounts were closed. 284. He never discussed CMOs with his parents. 290. He never participated in any discussions his mother may have had with Appellants about CMOs or about margin. 393. His mother never asked him to help her open her accounts or to complete paperwork. 374; 386; 390. Despite these huge and obvious holes in Rene's testimony, the EHP demonstrated no reluctance whatsoever in finding that his testimony "fully supported and corroborated" others' testimony. That makes no sense.

It makes even less sense considering that many of the findings in the Decision relating to CP are either wholly unsupported by the record (or even references to the record) or are contradicted by the record. For example, the Decision recites that CP "had no understanding of investments." Nothing is cited for this proposition. This is not surprising, given that CP never stated that. Or implied it. In fact, the only evidence in the record on the subject comes from Mr. Kline, who testified that CP, who had a Master's degree (2662), "had more than a cursory understanding of how investments worked, since she and her husband had invested for, I think, perhaps 30 years." 2662. Mr. Kline testified specifically – and this testimony is un rebutted – that he did have discussions with CP about CMOs, and, to his knowledge, she understood them. 2665; 2677.

The Decision recites that Mr. and Mrs. P's "investment experience consisted of long-term investments in blue chip stocks." Decision at 30. Nothing is cited for this proposition, and there is nothing in the record to support it.

The Decision recites that Mr. Kline "told them they could not lose money in CMOs because they were government-guaranteed bonds." *Id.* at 31. Nothing is cited for this, and there is nothing in the record to support it.

The Decision recites that after his father's death, Rene "began helping his mother with her investments and spoke to Kline on her behalf." *Id.* at 31. Nothing is cited for this, and the record actually

"was concerned for his son's ability to handle his own money and that was also one of the reason [sic] why they established their trust agreements the way they did and asked if I would be willing and interested in being his advisor." 2678. All in all, it seems clear that Rene's father had quite a bit more than "some" investment knowledge. This serves as yet another example of the EHP's selective view of the evidence, merely in an effort to support an otherwise unsupportable finding.

contradicts it. Indeed, Mr. Brown, the FINRA examiner, conceded that **Reese** only got involved “[t]owards the tail end of their experience with Brookstone.” 1294.

The Decision recites that Mr. Kline “changed the new account forms for the accounts to reflect a more aggressive investment objective.” Decision at 31. While the Decision cites to three particular pages from the Transcript as the supposed support for this finding, nowhere on those pages is there any testimony that, in fact, reflects what the EHP claims. Why the EHP attributed this finding to those pages is a mystery. The Decision also recites that “[t]here were no changes in CP’s personal circumstances between 2004 and 2005 that would explain the changes to the new account forms.” *Id.* at 32. Again, six pages from the transcript are cited as support for this, but those pages do not even address the subject.

The EHP’s misplaced reliance on **Reese**’s testimony as support for its conclusions is, given all the problems noted above, reason enough to reverse the finding of liability. It was beyond serious. It was egregious.

b. Mr. and Mrs. G

As part of its continuing parade of hearsay testimony, FINRA elected to attempt to prove the allegations relating to Mr. and Mrs. G not by calling either of them as witnesses (while Mr. G is deceased, Mrs. G is not), but, instead, by calling their son, **Arthur**. There are a myriad of problems with his testimony. The first stems from the reason he was there in the first place.

The EHP found that **Arthur** “was reluctant to testify,” but that is not true. What he said was that if he had not been compelled to appear through the issuance of an 8210 letter – **Arthur** is an equity trader associated with a broker-dealer, and, thus, is subject to 8210 – he was “not sure” that he would have testified. 692. Importantly, he did not say why he was unsure, and DOE never bothered to ask. Regardless, he was not “reluctant.” The EHP also found that **Arthur** stated that his mother “was afraid if she testified against Brookstone and Kline, they would not pay her” pursuant to the settlement her lawyers had negotiated to resolve the arbitration claim she had filed against them. Decision at 35. In fact, **Arthur** never said that. What he said was that she “just didn’t want to jeopardize anything.” 689; 737. That is

hardly the same thing; just one more example of the EHP misstating and embellishing the record in its effort to substantiate its ruling.

The bigger problem with A's testimony, however, is that the EHP relied on it to corroborate his mother's hearsay Declaration. Not surprisingly, given that Mr. Brown drafted all the customer Declarations, it contained the same accusations against Appellants as the others. Yet, even as it became obvious that A had essentially zero knowledge to enable him to corroborate his mother's supposed remarks, it did not seem to matter to the EHP: He never met Mr. Kline. (683) He never provided advice to his parents about their investments. (693) While he thinks his parents had limited investment experience, he never discussed this with them, and so had no personal knowledge. (694) He had no knowledge of their financial situation. (694) He did not know if the information on the new account form regarding their investment objective was accurate or not. (711) He did not know if the margin agreement was even used in connection with his parents' account. (713-714) He played no role in completing any new account forms after his father died. (751)

Despite these admissions, the EHP nevertheless concluded that A "became more involved in Mrs. JG's finances" after his father died. Decision at 35. This finding is flat out contradicted by A's testimony that until the accounts were closed and the assets sent to TD Ameritrade – which he then managed himself¹⁹ – he had "zero," or "none," involvement in the direction of his parents' accounts. 721.

The EHP again makes much of the fact that there are different new account forms with different investment objectives and risk tolerances, but, apart from Mrs. G's Declaration, there is no support for the finding there was no explanation for those changes. Decision at 35.

c. HP

DOE's effort to prove the allegations related to HP's investments was the least robust of any of the eight customers involved here. Not only did they not call HP (who had passed away as of the date of

¹⁹ One of the oddest moments of this case came when A testified about the manner in which he invested his mother's money at TD Ameritrade. According to A, he used an equity strategy that involved making "short-term bets" on stocks. Yet, somehow, remarkably, he characterized this as "pretty conservative." 705

the hearing), they decided not to call anyone.²⁰ The only evidence concerning HP came in the form of hearsay testimony from Mr. Brown, who related conversations that he supposedly had with HP prior to his death, and a hearsay Declaration prepared by Mr. Brown for HP to sign. As is typical when such Declarations are employed in disciplinary hearings, the EHP admitted it over objection from Appellants, allowing it in "for what it's worth." 1329. It turns out, of course, that it was worth quite a lot in the eyes of the EHP. So much, in fact, that it constitutes reversible error.

The reason for this is that the Declaration (CX-176), which the EHP expressly found to be "credible and reliable," was anything but. Decision at 37. Most importantly, the EHP determined that HP was "financially unsophisticated, and that he had always relied on brokers for investment advice," id., based on the contents of the Declaration and the fact that it was consistent with Mr. Brown's testimony about his conversations with HP. But documentary evidence²¹ produced by DOE clearly belies HP's statement in his Declaration that he only had limited investment experience. By his own admission, he had owned securities accounts since the mid-1990s, accounts worth millions of dollars. In those accounts, he traded a wide variety of securities, including many different stocks, some of which were speculative, over-the-counter stocks. RX-43. HP also used margin extensively, and conceded in his Declaration that he understood that the use of margin could magnify his losses.

Contrary to the EHP's conclusion, the evidence adduced regarding HP does not present a clear picture of a supposedly unsophisticated, inexperienced investor. To reach that conclusion, it is necessary to ignore the clear import of his account documentation and, instead, rely exclusively on questionable hearsay testimony. That is not only unfair, it is plain error.

²⁰ While HP may not have had family members available, Mr. Brown testified that he did speak with HP's attorney about HP's investments. 1328; 1659. For whatever reason, however, DOE did not even try to call him as a witness.

²¹ FINRA issued 8210 requests to Salomon Brothers and Raymond James to obtain documents they each maintained relating to HP's accounts. Mr. Brown testified that he received new account forms from each. 1661. While such documents may have shed a good deal of light on HP's investment objective and risk tolerance, these documents were never produced in discovery.

d. SB

SB did not appear and testify at the hearing. Instead, DOE played a video deposition that SB provided long before the hearing. As outlined above, for several reasons, the EHP's decision to admit the deposition was erroneous, so erroneous, in fact, that the HO correctly anticipated that the ruling would constitute a ground for reversal on appeal. 1087. But there is no need to repeat these arguments.

The single biggest issue with SB's deposition testimony is that it was not competent. The EHP begrudgingly acknowledged that his "memory was not complete" (Decision at 40), but that hardly captures what really happened. In fact, SB could barely remember anything, even with the (inappropriate) assistance of his wife: He admitted he sometimes forgets his own name. (B Transcript – "BT" – at 65) He did not recall who FINRA was. (BT 74) He could not remember all of his accounts, including accounts containing over \$900,000 worth of annuities. (BT 63) He did not remember preparing, reading, or signing the Declaration that Mr. Brown drafted. (BT 73) Indeed, he testified that he might even have signed it without bothering to read it. (BT 74) He could not remember having any telephone conversations with anyone from FINRA. (BT 57)

Whether or not SB's patent lack of competence should have served as a valid ground for excluding his deposition from the record may be an unusual question for the NAC to resolve, given that credibility is typically an issue related to the "weight" of the evidence, not its admissibility. What is not debatable, however, in light of SB's serious memory loss, is that the EHP erred in finding his testimony to be "credible and reliable." Decision at 40.

As with HP, there were also serious contradictions between SB's Declaration and testimony, on the one hand, and his account documents, on the other. While the former were cited by the EHP as support for its conclusions that SB was inexperienced and unsophisticated and disliked investments that presented risks, the latter demonstrate the complete opposite, that he had considerable experience with sophisticated investments, including investments generally deemed to carry relatively higher risks. It is undisputed that before he ever invested with Appellants, SB invested in at least four high yield municipal

bond funds.²² The prospectuses for each of those funds clearly reveal that they were invested in junk bonds, i.e., bonds of low credit quality, with a greater risk of default than highly rated bonds. RX-76, 77, 78, 79. If that was not enough, SB's Raymond James account statement reflects that he actually owned CMOs as far back as 2001, long before he met Appellants. RX-16. This undisputed evidence was ignored by the EHP, which elected, instead, to rely on the supposedly reliable testimony of a man who could not remember his own name.

E. If Liability For The Underlying Charges Is Not Found, Then The Supervision Charges Against Dave Locy, Which Are Entirely Derivative, Must Also Be Dismissed.

Supervision claims are necessarily derivative of a finding of a primary violation by a person supervised by the respondent. Supervision claims also require a finding that the supervisor was unreasonable in his or her discharge of obligations under NASD Rule 3010. As the transactions at issue here were suitable, there could be no failure to supervise claim against Brookstone or Messrs. Turbeville and Locy.

Further, the EHP's findings concerning Mr. Locy's failure to review of discretionary accounts is erroneous. The EHP found that Mr. Locy "could not identify any instances in which he had reviewed a CMO cash or margin discretionary account during his monthly reviews. And he admitted that he did not have any documentation to substantiate his claims that he ever reviewed discretionary accounts." Decision at 58. In fact, Mr. Locy testified that he did conduct monthly reviews of discretionary accounts, including the accounts of the complaining customers, and demonstrated this review as evidenced in RX-100.²³

²² It is also noteworthy that SB's Raymond James account statements reflect that certain junk bonds of his were transferred in from another broker-dealer. The identity of that broker-dealer is unknown, and FINRA never bothered to explore that. It is anyone's guess how long SB may have had that account, or what he had in it besides the high yield funds.

²³ Mr. Locy testified that the records from 2005 and 2006 did not include account numbers. However, this statement does not mean that Mr. Locy did not review these accounts or that he has no documents substantiating his review. Moreover, while Mr. Locy testified that firms are required to keep and maintain documents for six years after the account has closed, that is not, in fact, accurate. Under SEC Rule 17a-4(e)(8), for instance, exception reports are only required to be maintained for 18 months after the date the report was generated; under 17a-4(e)(7), written supervisory procedures are maintained for three years after termination of use. Mr. Locy may not have

F. Even If Liability Is Found, The Sanctions Meted Out By The EHP Were Punitive, Not Remedial, And Must Be Reduced Significantly.

The EHP found aggravating factors which warranted an upward departure from the Sanction Guidelines for the imposition of sanctions against Brookstone, including findings that Brookstone's conduct, through Messrs. Turbeville, Kline and Locy, was intentional. As discussed above, the EHP failed to identify any conduct evidencing scienter. As such, to the extent that the NAC reverses the findings as to liability, the fines imposed should be reduced accordingly. Similarly, the EHP's order barring Messrs. Turbeville, Kline and Locy should be reversed or adjusted in accordance with the arguments discussed herein.²⁴

Additionally, with regard to the amounts of restitution ordered by the Decision, Appellants have disputed the figures presented by DOE as "cherry picking" the losses during the time period chosen by DOE – from a high water to a low water mark. Moreover, some customer claims were already settled.

The restitution order should also be vacated on a separate ground. Appellants were deprived of customer records reflecting profits and losses incurred by the customers for prior time periods, including time periods when the customers admitted they were profitable. In this regard, the restitution order incorrectly creates a windfall in favor of the customers. Further, Appellants settled claims with MR and BC and were released from liability due to them. As a result, MR and BC are not entitled to receive restitution from Appellants as their claims were extinguished prior to the Decision.

III. CONCLUSION

Seemingly from the outset of this disciplinary proceeding, the HO embarked on a series of wrong-minded decisions that led this case inevitably to this appeal. Indeed, as noted above, on occasion, the HO appeared herself to anticipate that her rulings were so questionable that an appeal would be

recalled the exact time period for retaining records of his review, but he should not be punished for failing to review discretionary accounts as a result of this lack of knowledge.

²⁴ What is particularly egregious is the EHP's decision to bar Mr. Locy from acting as a supervisor for "ignor[ing] his responsibility as chief compliance officer to review the discretionary accounts of Brookstone customers." Decision at 67. As discussed above, Mr. Locy did review the accounts and did testify that there was written records of that review, which contradicts the findings by the EHP. Accordingly, any bar would be inappropriate for Mr. Locy.

automatic. The good news for Appellants is that this review by the NAC is independent and *de novo*, meaning all the findings in the Decision are subject to reversal, including all findings relating to liability as well as to sanctions.

Even when confronted with the relatively easier civil "preponderance of evidence" standard for meeting its burden of proof, DOE was unable to get the job done. It relied on a host of incompetent testimony, most of it in the form of hearsay. It ignored any document, even if signed, initialed, or notarized, if it failed in any way to fit the Staff's theory of the case. It used its power under Rule 8210 in a manner that was unfair and prejudicial to Appellants.

The NAC has the power to rectify these errors committed by the Staff and the EHP. For all the reasons outlined above, as well as the arguments made in Appellants' Post-Hearing Brief, the findings should be reversed.

Dated: October 12, 2012

Respectfully submitted,

By: 

Alan M. Wolper, Esq.
Nathan W. Lamb, Esq.
Ulmer & Berne, LLP
500 W. Madison St., Ste. 3600
Chicago, Illinois 60661-4587
Email: awolper@ulmer.com
Email: nlamb@ulmer.com

James. D. Sallah, Esq.
Joshua A. Katz, Esq.
Sallah & Cox, LLC
2101 NW Corporate Blvd., Ste. 218
Boca Raton, Florida 33431
Email: ids@sallahcox.com
Email: jkatz@sallahcox.com

Attorneys for Appellants

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

Department of Enforcement,

Complainant,

v.

Brookstone Securities (CRD No. 13366),
Antony Lee Turbeville (CRD No. 1721014),
Christopher Dean Kline (CRD No. 2597293) and
David William Locy (CRD No. 4682865)

Respondents.

No. 20070011413501

CERTIFICATE OF SERVICE

I hereby certify, on this 12th day of October, 2012, I sent the foregoing Appellants' Appeal Brief to be served as follows:

Original + 1 copy via regular mail and
via electronic mail:

Gary Dernelle, Esq., Associate General Counsel
FINRA, Office of the General Counsel
1735 K Street, NW,
Washington, DC, 20006-1506
nac.casefilings@finra.org

1 copy via regular mail and
via electronic mail:

Karen E. Whitaker, Esq.
Senior Regional Counsel
FINRA
Department of Enforcement
12801 North Central Expressway, Suite 1050
Dallas, Texas 75243
karen.whitaker@finra.org

1 copy via regular mail and
via electronic mail:

David B. Klafter, Esq.
Regional Chief Counsel – Southern Region
FINRA
Crystal Corporate Center
2500 N. Military Trail, Suite 302
Boca Raton, FL 33431
David.Klafter@finra.org

1 copy via regular mail and
via electronic mail:

Adam Walker
FINRA
120 West 12th Street, Suite 800
Kansas City, MO 64105,
Adam.Walker2@finra.org



Alan M. Wolper

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
NATIONAL ADJUDICATORY COUNCIL**

Department of Enforcement,

Complainant

v.

**Brookstone Securities, Inc.
(CRD No. 13366),**

**Antony Lee Turbeville
(CRD No. 1721014),**

**Christopher Dean Kline
(CRD No. 2597293), and**

**David William Locy
(CRD No. 4682865)**

Respondents

**DISCIPLINARY PROCEEDING
No. 2007011413501**

DEPARTMENT OF ENFORCEMENT'S BRIEF

**Karen E. Whitaker, Senior Regional Counsel
FINRA Department of Enforcement
12801 North Central Expressway, Ste. 1050
Dallas, TX 75243
972/716-7610 (voice)
972/716-7612 (fax)
karen.whitaker@finra.org**

**Adam B. Walker, Principal Regional Counsel
FINRA Department of Enforcement
120 West 12th Street, Suite 800
Kansas City, MO 64105
816/802-4751 (voice)
816/421-4519 (fax)
adam.b.walker@finra.org**

November 29, 2012

CONTENTS

AUTHORITIES	i
INTRODUCTION	1
FACTS	4
A. Background	4
B. Brookstone's CMO Program	4
C. The Customers	5
ARGUMENT	6
I. THE CMO TRADES WERE UNSUITABLE FOR THE CUSTOMERS.....	6
A. The Evidence Of The Stratospheric Risk Inherent In Respondents' CMO Trading Is Extensive And Uncontradicted.....	7
B. By Willfully Ignoring "Effective Duration," Turbeville And Kline Prevented Themselves From Fully Understanding the Extreme Risk Of Their CMO Trading	9
C. None Of The Seven Brookstone Customers Was A Sophisticated Investor Or Had A High-Risk Profile.....	9
D. Even if the Customers Sought "Aggressive Income," Turbeville and Kline Could Not Have Reasonably Believed That Their CMO Strategy Was Suitable For Any Of The Seven Customers.	14
E. Turbeville and Kline Cannot Use Generic Written Disclosures To Circumvent Their Obligations Under Rule 2310	15
II. THE HEARING PANEL CORRECTLY FOUND THAT BROOKSTONE, TURBEVILLE AND KLINE MADE FRAUDULENT MISREPRESENTATIONS AND OMISSIONS IN CONNECTION WITH THEIR CMO SALES TO CUSTOMERS.....	17
A. Brookstone, Turbeville And Kline Acted With Scienter.....	17
B. Respondents' Brief Misstates The Law Regarding The Effect Of Disclosures On Fraudulent Statements and Omissions.....	18

III. THE HEARING PANEL'S WITNESS CREDIBILITY DETERMINATIONS AND EVIDENTIARY RULINGS WERE PROPER.....	22
A. The Hearing Officer Correctly Denied Respondents' Request To Require FINRA To Sweep The Ten Largest Clearing Firms In The Securities Industry For Documents That Might or Might Not Exist.....	26
IV. THE RECORD FULLY SUPPORTS FINDINGS THAT LOCY FAILED TO ADEQUATELY SUPERVISE TURBEVILLE'S AND KLINE'S CMO TRANSACTIONS AND THAT HE FAILED TO SUPERVISE DISCRETIONARY ACCOUNTS AND TRANSACTIONS	29
CONCLUSION	31

AUTHORITIES

CASES

<i>DOE v. Frankfort</i> , 2007 NASD Discip. LEXIS 16 (NAC, May 2007)	16
<i>Robert A. Foster</i> , 51 S.E.C. 1211, 1213 n.2 (1994)	16
<i>Ross Secs., Inc.</i> , 41 S.E.C. 509, 510 (1963)	16
<i>Larry Ira Klein</i> , 52 S.E.C. 1030, 1036 (1996).....	16
<i>DOE v. James B. Chase</i> , No. C8A990081 (NAC Aug. 15, 2001)	16
<i>Ernst & Ernst v. Hochfelder</i> , 425 U.S. 185, 193 (1976)	18
<i>In re Westcap Enterprises</i> , 230 F.3d 717 (5 th Cir. 2000).....	18
<i>Banca Cremi, S.A. v. Alex Brown & Sons, Inc.</i> , 132 F.3d 1017 (4 th Cir. 1991).	20
<i>Brown v. E.F. Hutton Group, Inc.</i> , 991 F. 2d 1020 (2d Cir. 1993)	21
<i>Keith L. DeSanto</i> , 52 S.E.C. 316, 319 (1995), <i>aff'd</i> , 101 F.3d 100 (2d Cir. 1996).	22
<i>Anthony Tricarico</i> , 51 S.E.C. 457, 460 (1993).....	22, 23
<i>Dep't of Enforcement v. Mizenko</i> , Complaint No. C8B030012, 2004 NASD Discip. LEXIS 20, at *16 n.11 (NAC Dec. 21, 2004), <i>aff'd</i> , Exchange Act Rel. No. 52600, 2005 SEC LEXIS 2655 (Oct. 13, 2005).....	22
<i>Department of Market Regulation v. Marshall J. Field</i> , No. CMS040202, 2008 FINRA Discip. LEXIS 63, at *22-25 (NAC Sept. 23, 2008)	23
<i>Alvin W Gebhart</i> , Exchange Act Rel. No. 53136, 2006 SEC LEXIS 93, at *19 n.18 (Jan. 18, 2006), <i>rev'd in part and remanded on other grounds</i> , 255 F. App'x 254 (9th Cir. 2007)	23
<i>Harry Gliksman</i> , 54 S.E.C. 471, 480-81 (1999), <i>aff'd</i> , 24 F. App'x 702 (9th Cir. 2001).	24
<i>Scott Epstein</i> , Exchange Act Release No. 59328, 2009 SEC LEXIS 217 at *46-47 (SEC Jan. 30, 2009).....	25
<i>Otto v. SEC</i> , 253 F.3d 960, 966 (7th Cir. 2001).....	25
<i>See Edgar B. Alacan</i> , Securities Act Rel. No. 8436, Exchange Act. Rel. No 43370, 2004 SEC Lexis 1422, at *23-24 (July 6, 2004).....	25

<i>DOE v. Medeck</i> , No. E9B2003033701, 2009 <i>FINRA Discip. LEXIS</i> 7, at *53-43 (NAC Jul. 30, 2009)	27
<i>Robert J. Prager</i> , Exchange Act Rel. No. 51974 (July 6, 2005), 85 <i>SEC Docket</i> 3413, 3432-33 & n.52	29
<i>David J. Dambro</i> , 1993 <i>SEC LEXIS</i> 1521, at *14 (June 18, 1993)	30
<i>DOE v. Douglas</i> , No. C10000026, 2002 <i>NASD Discip. LEXIS</i> 3, at *19 (NAC March 25, 2002)	30
<i>DOE v. Faber</i> , CAF010009, 2003 <i>NASD Discip. LEXIS</i> 3, at *41 (NAC May 7, 2003), <i>aff'd</i> 2004 <i>SEC LEXIS</i> 277 (Feb. 10, 2004);	30

OTHER AUTHORITIES

<i>NASD Notice to Members</i> 93-73	6
<i>NASD Notice to Members</i> 98-96	29
<i>NASD Notice to Members</i> 99-86, 1999 <i>NASD LEXIS</i> 63, at *2, entitled, "NASD Regulation Adopts Policy Regarding Imposition and Collection of Monetary Sanctions" (October 1999) ...	30
<i>General Principle No. 5, Sanction Guidelines</i>	30

RULES

<i>NASD Conduct Rule</i> 2310	15, 27
<i>NASD Rule</i> 8210	28

INTRODUCTION

The Extended Hearing Panel correctly found that, from July 2005 to July 2007, Respondents Brookstone Securities, Inc., Antony Turbeville and Christopher Kline engaged in a sustained effort to defraud seven elderly, retired customers by engaging in discretionary trading of complex, high-risk collateralized mortgage obligations (CMOs) with the customers' retirement funds. Respondents' trading activities resulted in significant financial losses for the customers, but a windfall for Respondents. Given the high-risk nature of the CMOs, and Respondent's failure to fully understand and mitigate that risk, Respondents had no reasonable grounds for believing that their investment recommendations were suitable for the unsophisticated elderly and retired customers, who ranged in age from 61 to 91 years old and who generally sought income with limited risk to their retirement funds. For some customers, the risk was magnified by Respondents' purchases of CMOs on margin in the customers' accounts. For their unsuitable investment recommendations, the Hearing Panel barred Turbeville and Kline in all capacities and fined Brookstone \$300,000.

The Hearing Panel also found that Brookstone, Turbeville and Kline made material misrepresentations and omitted material facts in connection with their sales of the high-risk CMOs, and failed to adequately disclose the risks associated with the CMO investment strategy that they employed in the customers' accounts. The Hearing Panel correctly found that Respondents' misstatements and omissions constituted fraud and imposed a separate bar in all capacities against both Turbeville and Kline and fined Brookstone \$500,000.

In addition, the Hearing Panel found that Brookstone and David Locy, the firm's former Chief Compliance Officer, failed to adequately supervise Turbeville's and Kline's CMO sales and

failed to adequately supervise the customers' discretionary accounts and transactions.¹

The Hearing Panel fined Brookstone a total of \$1,000,000 for its various violations, and ordered the firm to make restitution to the customers in the amount of \$1,620,100, of which \$440,600 was imposed jointly and severely with Turbeville, and the remaining \$1,179,500 was imposed jointly and severely with Kline.

Rather than grapple with the enormity of the risk to which they subjected the seven elderly and retired customers by investing their retirement savings in high-risk, illiquid inverse floater collateralized mortgage obligations (CMOs) bonds, Respondents attempt to shift the focus away from their own conduct. They suggest – all evidence to the contrary – that the customers at issue were sophisticated, aggressive investors who knew and accepted the risks of the CMO strategy that Respondents foisted on them. Ignoring the overwhelming record supporting the Hearing Panel's findings, Respondents dwell on evidence that they mistakenly contend was improperly excluded or omitted, complain that the Hearing Officer declined to let them go on a fishing expedition in the records of other firms for documents that would have been irrelevant in any event, and, in the face of the Hearing Panel's express credibility findings, insist that damaging customer testimony was not credible.

Respondents' various evidentiary and credibility arguments are baseless. But even if every last one of them were valid, none of the evidence that Respondents would have added to or excluded from the hearing record could have changed the fact that Brookstone, Turbeville and Kline subjected their customers to levels of risk many times greater than was appropriate, or that,

¹ For his violations, the Hearing Panel fined Locy \$25,000, suspended him in all capacities for two years, and barred him as a principal and supervisor.

The Hearing Panel also found that Brookstone and Turbeville made false and misleading statements in communications with their customers.

as a direct result of the unsuitable transactions that Respondents executed in their customers' accounts, the customers suffered substantial losses of their retirement funds.

Respondents' brief boils down to two basic arguments. First, Respondents contend that they fully disclosed the risks of their CMO trading activity to the customers, and, therefore, that their various misstatements and omissions concerning their CMO trading cannot be grounds for fraud. Second, they argue that the customers were savvy, aggressive investors who both understood and accepted the risks involved in Respondent's CMO trading strategy. Both arguments fail.

The level of risk that Turbeville and Kline subjected their customers to was enormous. Proof of the elevated risk levels in the customers' portfolios is not contradicted by anything in the hearing record. The risk in the customers' accounts reached such extremes that it made Turbeville's and Kline's CMO investment strategy unsuitable for virtually *any individual investor*. Thus, even if some or all of the customers had sought "*aggressive income*," as Respondents contend, there would still have been an unbridgeable gulf between what was appropriate for them as individual investors and the riskiness of the CMO portfolios that Turbeville and Kline constructed.

Respondents misguidedly assert that, by providing customers with general risks disclosures regarding CMOs, they had insulated themselves against fraud charges for their material misrepresentations and omissions in connection with their CMO sales. As a legal proposition, this is an appalling overreach, as the cases that Respondents cite say nothing of the sort. Moreover, the argument incorrectly presupposes that *Turbeville and Kline* fully understood the risks that they were creating, and that they had conveyed the enormity of that risk to their customers. As the hearing record shows, they did not. Thus, there is no support in either the

case law or the hearing record for Respondents' outrageous assertion that their fraudulent misstatements and omissions are obviated by supplying generic risk disclosures to customers.

The Hearing Panel's findings are fully supported by the evidence and warrant imposition of the sanctions ordered. The Hearing Panel's decision should be affirmed in all respects.

FACTS

A. BACKGROUND²

Turbeville and Kline began recommending the purchase of CMOs to each of the seven customers at issue in this matter prior to registering with Brookstone.³ Accordingly, all of the initial CMO sales to the customers were made by Turbeville and Kline while they were registered with other FINRA member firms. Brookstone became a FINRA member in 2005, after which Turbeville and Kline transferred each of the seven customers' accounts to Brookstone and continued the discretionary CMO trading in each account through July 2007. While Turbeville and Kline continued trading the customers' accounts at Brookstone, they never corrected any of the misrepresentations and omissions that they had made to the customers to induce them to begin trading in CMOs in the first place.

B. BROOKSTONE'S CMO PROGRAM⁴

Each month between July 2005 and July 2007, Brookstone purchased large blocks of CMO bonds, ranging in value from approximately \$97,000 to over \$5 million, from a third-party broker-dealer. Turbeville and Kline then sold existing CMO bond positions out of their

² See *Appendix A*, attached hereto and incorporated by reference, for a discussion of Respondents' backgrounds and disciplinary histories.

³ References to the Record are cited as "R-," references to the hearing transcript are cited as "Tr," Complainant's exhibits are cited as "CX-," and Respondent's exhibits are cited as "RX -." Tr. 1711(R-004273); Tr. 2655 (R-005421).

⁴ See R-000789-000826 and R-001053-001062, Expert Report of H. Gifford Feag for a detailed discussion of the CMO bonds purchased by Brookstone, Kline and Turbeville for the customers' accounts, and the market conditions during the period from July 2005 to July 2007.

customers' accounts and replaced them with the newly acquired CMOs, which were often priced closer to par. In many instances, losing bonds were sold at a discount, which caused customers to realize losses. The ostensible reason for these sales was to purchase bonds with higher coupons.

Turbeville and Kline constructed portfolios for their customers that consisted almost exclusively of CMOs, and were heavily – at times nearly entirely – concentrated in inverse floaters (IFs).⁵ For example, in January 2006, customer ~~Jeanne Grayson~~'s accounts had 93% of nearly \$1.5 million invested in IFs; customer ~~Charles Parnis~~'s accounts had 96% of over \$2.2 million invested in IFs; and customer ~~Michael Rents~~'s accounts had 93% of approximately \$2.3 million invested in IFs.⁶

Although their customers suffered significant losses as a result of Respondents' trading activity in their accounts, the activity was a source of financial gain for Respondents. Between July 2005 and July 2007, Respondents received approximately \$492,500 in commissions from trading activity in the accounts of the seven customers at issue here.⁷ During the same period, the customers suffered losses of approximately \$1,620,100.⁸

C. THE CUSTOMERS

As the Hearing Panel correctly found, all of the customers in this matter were unsophisticated investors who had always relied on brokers to assist them with their investment needs. At the times that the customers met either Turbeville or Kline, they had become disillusioned by having incurred stock market losses and were looking for safe investment

⁵ CX-357A (R- 014023), 358A (R- 014027), 359A (R- 014031), 360A (R- 014035), 362A (R- 014043), 363A (R- 014047) and 364A (R- 014051).

⁶ Fong Rept., R-000807.

⁷ CX-284 (R-012667-012840).

⁸ CX-357A (R- 014023), 358A (R- 014027), 359A (R- 014031), 360A (R- 014035), 362A (R- 014043), 363A (R- 014047) and 364A (R- 014051).

alternatives. Turbeville and Kline led the customers to believe that they had the answer – in the form of esoteric investment products that would supposedly allow the customers to preserve capital while generating 10 to 15% returns. Based on such representations, the customers transferred their retirement assets to Turbeville or Kline and authorized them to trade CMOs on a discretionary basis in their accounts. Some of the customers also authorized Turbeville and Kline to do so on margin.

At the time of the activity under review, none of the customers in this matter knew each other. Nonetheless, they all had similar recollections of Turbeville's and Kline's statements regarding CMOs and their CMO investment strategy. The inadequacy of Turbeville's and Kline's risk disclosures to the customers regarding investing in CMOs is evident from the fact that the customers have uniformly stated that they were led to believe that CMOs were safe investments for their retirement funds.

ARGUMENT

I. THE CMO TRADES WERE UNSUITABLE FOR THE CUSTOMERS

The starting point of any suitability analysis involving CMOs is *Notice to Members 93-73*, which addresses the risks of CMOs generally and of particular types of high-risk tranches, such as IFs and *interest-only CMOs*.⁹ With respect to IFs, the primary CMOs purchased by Respondents for the customers at issue, *NTM 93-73* states that they are high-risk products that are "*only suitable for sophisticated investors with a high-risk profile.*"¹⁰

Respondents' strategy of creating customer portfolios that consisted almost entirely of IFs, and sometimes using margin to do so, exacerbated the already high risks noted in *NTM 93-*

⁹ CX-380 (R- 022885-022887).

¹⁰ *Id.*

73.¹¹ The resulting levels of risk from the CMO transactions in the customers' portfolios were so great as to be unsuitable for almost any individual investor. Thus, the risk levels were especially inappropriate for the unsophisticated, elderly and retired customers at issue here – even if they had been the aggressive investors that Turbeville and Kline try to make them out to be.

Moreover, Turbeville and Kline did not make any meaningful attempt to equip themselves with basic information about the interest rate risk in their customers' accounts. Without this readily available information, Respondents simply could not make an informed assessment of the risks involved in the CMO trading that they were doing on behalf of their customers.

A. THE EVIDENCE OF THE STRATOSPHERIC RISK INHERENT IN RESPONDENTS' CMO TRADING IS EXTENSIVE AND UNCONTRADICTED.

DOE presented testimony from H. Clifford Fong, an expert in valuing and analyzing the risks of fixed income products. Fong analyzed the customers' accounts and observed that Turbeville and Kline subjected their customers to high concentrations of IFs.¹² Fong testified that IFs "are very risky because in general they have a very high effective duration, which means they have a very high sensitivity to interest rate change."¹³ Effective duration, as Fong explained, is the standard measurement of interest rate risk for fixed income products.¹⁴

Over time, Turbeville and Kline increased the concentration of IFs in their customers' accounts. As they did this, Fong's analysis showed that the overall effective duration in the accounts climbed.¹⁵ Turbeville and Kline further increased the effective duration in some customers' accounts through the use of margin. As Fong explained, the use of margin acts as a

¹¹ Tr. 791-92 (R-002776-002777).

¹² Tr. 834, 850-51 (R-002819, R-002835-002836).

¹³ Tr. 809 (R-002794).

¹⁴ Tr. 789, 821 (R-002774, R-002806).

¹⁵ Tr. 836-37 (R-002821-002822).

multiplier of the portfolio's effective duration.¹⁶ For example, as of July 29, 2005, the effective duration in customer P[REDACTED]'s portfolio was 10.8 before accounting for the use of margin; with margin figured in, the effective duration was nearly 20.¹⁷

F[REDACTED] calculated the overall effective duration for each customer's investment portfolio,¹⁸ and testified that Turbeville and Kline made the portfolios *many times riskier* than was appropriate for the customers.¹⁹ As F[REDACTED]'s testimony and expert report show, the effective duration figures that were present in the accounts of Turbeville's and Kline's customers were at levels that are unsuitable for individual investors.²⁰

At the hearing, Respondents offered no evidence refuting F[REDACTED]'s effective duration analysis. Tellingly, none of the evidence that Respondents seek either to add to or exclude from the record relates to the riskiness of CMOs that they purchased. Thus, they do not identify any putative grounds for upsetting the Hearing Panel's findings that Turbeville and Kline purchased large quantities of IFs for their customers, sometimes on margin, without making any effort to limit the interest rate risk they were importing into the customers' portfolios.²¹

¹⁶ Tr. 845-46 (R-002830-002831).

¹⁷ Tr. 847 (R-002832); Fong Rept., Exhs. 6, 7 (R-000808, R-000809).

¹⁸ Fong Rept., 19-20 (R-000808-000809).

¹⁹ Tr. 830-31, 834-35, 840-41 (R-002815-002816, 002819-002820, 002825-002826).

²⁰ Tr. 840-41 (R-002825-002826).

²¹ The only glancing mention of the Hearing Panel's findings on this subject comes in connection with Respondents' contention that Mr. Fong's testimony should have been excluded. According to Respondents, "Mr. Fong's testimony concerning the risks involved in investing in CMOs . . . was derived by disregarding the new account forms and risk disclosures which the customers signed and/or initialed . . ." Respondents' Br., at 15 (emphasis added). This is false, or, at best, confusing. CMOs are risky investments, regardless of who buys them. Thus, Mr. Fong properly testified that IFs are extremely risky products without adverting to the risk profiles of eight individual investors.

B. BY WILLFULLY IGNORING "EFFECTIVE DURATION," TURBEVILLE AND KLINE PREVENTED THEMSELVES FROM FULLY UNDERSTANDING THE EXTREME RISK OF THEIR CMO TRADING.

Just as Brookstone, Turbeville and Kline have ignored effective duration throughout this litigation, they also ignored it when they were trading CMOs in the customers' accounts. Although Turbeville and Kline each professed familiarity with the concept of "effective duration,"²² they gave no meaningful thought to using effective duration (or any other measure) to control interest rate risk when constructing their customers' CMO portfolios.²³ Turbeville and Kline did not pay attention to effective duration figures for individual CMO bonds, although those figures were readily available to them, and did not calculate effective duration for individual customer portfolios.²⁴

Without this critical information, it was impossible for Turbeville and Kline to appreciate the amount of risk they had created in their customers' accounts, and, thus, unreasonable for them to conclude that their CMO trading strategy was suitable for their customers.²⁵ The CMO strategy saddled ordinary individual investors with levels of risk that would typically be inappropriate for all but the most aggressive institutional investor, such as "a very aggressive hedge fund."²⁶

C. NONE OF THE SEVEN BROOKSTONE CUSTOMERS WAS A SOPHISTICATED INVESTOR OR HAD A HIGH-RISK PROFILE.

Nonetheless, Respondents contend that their CMO trades were suitable for their customers because those customers supposedly wanted to take aggressive risks in return for the

²² Tr. 1733 (R-004295); Tr. 3004 (R-005771).

²³ Tr. 875-76, 878 (R-002860-61, R-002863).

²⁴ Tr. 821-22, 831-32, 834 (R-002806-002807, R002816-002817, R-002819).

²⁵ Tr. 820-21 (R-002805-002806).

²⁶ Tr. 1012-13 (R-002998-002999).

possibility of high income. The evidence does not bear this out.²⁷ Turbeville and Kline offer a blame-the-victim solution to the problems created by their refusal to make any effort to control or mitigate the risk in their customers' accounts. They contend that the Hearing Panel erred in finding that the customers had little tolerance of or desire for risky investments. But the record abundantly supports the conclusion that none of the customers was a sophisticated investor or had a high-risk profile.

1. Customer Michael Rau

Customer ~~Rau~~page 76, (and his wife ~~Maria~~ Rau, age 66) testified that they met Turbeville in 2001, when they attended the *Senior Citizens Maximum Income and Asset Protection Seminar* hosted by Turbeville.²⁸ At that time, Rau had been retired for several years. Before retirement, Rau worked as a mobile homes salesman and had owned and operated car washes and convenience stores.²⁹ ~~Rau~~ had limited investment knowledge, and his investment experience consisted primarily of investing in CDs, money-market funds, municipal bonds and mutual funds.³⁰ Before meeting Turbeville, ~~Rau~~ had never invested in CMOs or invested on margin.³¹

~~Rau~~ and his wife later met with Turbeville to discuss ~~Rau's~~ financial needs. During that meeting, ~~Rau~~ told Turbeville that he did not want high-risk investments and that he could not

²⁷ Brookstone's new-account form listed five investment objectives to be ranked in order of relative priority. The form did not contemplate that any one objective would necessarily be exclusive of the other four. *See, e.g.*, CX-25 (R007079-007088).

²⁸ CX-335 (R-013747-52).

²⁹ Tr. 423-424 (R-002407-002408).

³⁰ CX-32 (R-007153-007156).

³¹ CX-32 (R-007153-007156); Tr. 459-460 (R-002443-002444).

afford to lose any of his retirement money at his age.³² R also told Turbeville that his investment goals included preservation of principal, above average returns, and liquidity.³³

2. Customer Barbara Carter

Carter is a former payroll clerk and teaching assistant who retired in February 2010.³⁴ She testified at hearing that, when she met Turbeville, she had very limited investment knowledge.³⁵ Her investment experience at that time consisted of investing through her 401(k) account.³⁶ She also had a brokerage account through which she sold shares of stock that she had received from her employer. She used the proceeds of those sales to invest in mutual funds and money markets. Before meeting Turbeville, Carter had never invested in CMO bonds.³⁷

Carter's liquid net worth at the time was approximately \$280,000. Her investment objectives were to generate income and to grow her retirement funds to help offset inflation.³⁸ During her initial meeting with Turbeville, Carter informed him that she was interested in transferring from Wachovia because her accounts had been losing money, and that she could not afford to lose any of her retirement funds.³⁹

3. Customer Betty Baker

Baker, an 88-year-old retired widow, met Turbeville when she attended a free-lunch seminar hosted by Turbeville in the late 1990s. Before her retirement, Baker had worked as a registered nurse. She had limited investment knowledge, and her investment experience

³² CX-32 (R-007153-007156); Tr. 474 (R-002458); Tr. 479-480 (R-002463-002464).

³³ CX-337 at 10 (R-013764).

³⁴ Carter initially retired in 2004, but due to insufficient retirement funds, she had to return to work as a teaching assistant earning \$18,000 per year from 2005 to 2010. Tr. 36-37 (R-002020-002021).

³⁵ Tr. 44 (R-002028).

³⁶ CX-17 at 6-7 (R-006544-006545).

³⁷ Tr. 42 (R-002026).

³⁸ CX-17 at 6 (R-006544).

³⁹ Tr. 39, 42-43 (R-002023, 002026-002027).

included investing in blue chip stocks and equity and bond mutual funds through an IRA and a trust account at Merrill Lynch. Baker had a total net worth of approximately \$140,000; liquid net worth of approximately \$140,000; and annual income of approximately \$14,400.⁴⁰

Following the seminar, Baker met with Turbeville to discuss her investment needs. She told him that she wanted to generate income for her required minimum distribution and hoped to still achieve some growth.⁴¹ Although she hoped to earn a better return than a bank savings account, Baker's risk tolerance was very low due to her age and financial situation. She did not want to invest in aggressive investments or risk losing her retirement savings.⁴²

4. Customer Carolyn P.

P., age 84, and her husband, who passed away in 2002, met Kline in 2001. At that time, they had both been retired for several years. P. had worked as a Home Economics teacher for 27 years before her retirement. She had no understanding of investments and had relied on her husband to handle the family's investments.⁴³ Until his death, P.'s husband had most of the contact with Kline. Their total net worth at that time was approximately \$4.5 million, their liquid net worth was \$4 million, and their annual income was approximately \$50,000. Through investing, they sought to generate income for their living expenses and preserve their capital.⁴⁴

Although subsequent new account forms for P. reflected increased risk tolerances and investment objectives, by no means did she ever become a sophisticated investor who sought to

⁴⁰ CX-23 (R-006831-006832).

⁴¹ *Id.*

⁴² *Id.*

⁴³ Tr. 274 (R-002258).

⁴⁴ *Id.*

subject her retirement assets to high levels of risk. At all times, her risk tolerance remained moderate.⁴⁵

5. Customer Jeanne Goymes

Goymes, age 81, became a customer of Kline in 2002. At the time, she was married. Both Goymes and her husband were retired. Goymes' husband died in 2005.

Goymes had been a homemaker and a real estate agent. Her husband had operated a shipyard. They had very limited investment knowledge and had always relied on brokers for investment advice. Before meeting Kline, they had never invested in CMO bonds or purchased securities on margin. Their prior investment experience included investing in blue chip stock, bonds, equity and bond mutual funds, variable annuities and REITs through brokerage accounts. Their total net worth was \$1.3 million, liquid net worth was \$1.3 million, and annual income was approximately \$20,000.⁴⁶

At no time did Goymes become a high-risk, sophisticated investor. Even the new account forms that Kline completed for Goymes after 2005 reflected only a *moderate* risk tolerance.⁴⁷

6. Customer Harold Papp

Papp, who died in 2011 at age 85, owned and operated a construction business until he retired in 1992. Papp began investing in the 1990s, placing most of his retirement assets in a diversified portfolio of stocks, treasury notes, and bonds, all of which were recommended to him by financial advisors. Papp became unhappy with his investments accounts after a downturn in the equity market.⁴⁸ Before meeting Kline in early 2002, Papp had never invested in CMOs.⁴⁹

⁴⁵ CX-98 at 3 (R-009771); CX-104 at 3 (R-009873); CX-105 at 2 (R-009882).

⁴⁶ CX-78 (R-008967-008968).

⁴⁷ CX-66 at 6-7 (R-008862-008863).

⁴⁸ CX-178 (R-010917-010918).

⁴⁹ *Id.*

During his initial meeting with Kline, Pope stated that he did not want to take much risk with his money at his age, and that his goal was to earn a steady interest income that he could live off of in his retirement.⁵⁰ His total net worth was approximately \$3 million, liquid net worth was in excess of \$2 million, and annual income was approximately \$34,000.⁵¹

7. Customer ~~Stated~~ "Safe" Bonds

B ~~met~~ met Kline in 2002 when he was age 89. B ~~was~~ was a retired school teacher with limited investment knowledge. His investment experience consisted primarily of investing in mutual funds, corporate and municipal bonds and annuities at the recommendation of investment advisers.

When he began investing with Kline, B ~~total~~ total net worth was approximately \$1,365,000, his liquid net worth was approximately \$315,000, and his annual income was approximately \$55,000.⁵² During his initial meeting with Kline, B ~~told~~ told Kline that he wanted his investments to be safe and secure, with no risk. At the time of the hearing, B ~~was~~ was 98 years old.

D. EVEN IF THE CUSTOMERS SOUGHT "AGGRESSIVE INCOME," TURBEVILLE AND KLINE COULD NOT HAVE REASONABLY BELIEVED THAT THEIR CMO STRATEGY WAS SUITABLE FOR ANY OF THE SEVEN CUSTOMERS.

Respondents point to new account documents reflecting that each of the customers sought to earn "aggressive income." This, they contend, indicates that the customers wanted and accepted the kinds of risks that were part of Turbeville's and Kline's CMO trading program. The record shows that the customers were not, in fact, aggressive investors. But in any event, a tremendous gap remains between what would have been appropriate for an investor seeking

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² CX-49 (R-007931-007933).

“aggressive income” and the enormous degree of risk to which Turbeville and Kline exposed their customers through their CMO trading.

The “aggressive income” designation that Respondents cleave to comes from a new account form that Brookstone used from 2005 through 2007. That form identifies various investment products that are typical of customers who seek “aggressive income.”⁵³ Fong testified that the overall effective duration in each customer’s portfolio was higher than any of the investment products that Brookstone’s new account form identified as appropriate for an investor seeking “aggressive income.”⁵⁴ “With a duration of 20,” Fong testified, “you are exceeding all of those products mentioned.”⁵⁵ As Fong’s un rebutted analysis showed, the overall effective duration rates in certain of the customer portfolios reached as high as 28 during the review period,⁵⁶ which is why the CMO transactions executed by Turbeville and Kline were far too risky for their customers, regardless of whether they, in fact, sought “aggressive income.”

E. TURBEVILLE AND KLINE CANNOT USE GENERIC WRITTEN DISCLOSURES TO CIRCUMVENT THEIR OBLIGATIONS UNDER RULE 2310.

Respondents argue that the generic written disclosures that they provided to the customers insulate them both from fraud charges for material misrepresentations and omissions, and from charges of unsuitable investment recommendations. They are wrong on both counts.

Under NASD Conduct Rule 2310, a broker-dealer and its registered representatives must have reasonable grounds for believing that a security is suitable for a customer before

⁵³ See, e.g., CX-25 (R-007079-007088) (identifying “lower quality, short and medium-term fixed income products, high-quality long-term fixed-income products and aggressive bond funds” as typical investments for a customer with an “aggressive income” objective).

⁵⁴ See Tr. 839-40 (R-002824-002825).

⁵⁵ *Id.* at 840 (R-002825).

⁵⁶ Fong Rept., Exh. 7 (R-000809). By July 2007, the effective duration in each customer’s portfolio exceeded 25. *Id.*

recommending it to the customer.⁵⁷ A broker cannot evade this requirement by separately disclosing some or even all of the risks of the investment to the customer.⁵⁸ In all cases, a recommendation may properly be made only after the broker has reasonably concluded that the security is suitable for the customer, given the customer's needs, financial outlook, investment experience and knowledge, and other factors. As the NAC has stated, "[a]lthough it is important for a broker to educate clients about the risks associated with a particular recommendation, *the suitability rule requires more from a broker than mere risk disclosure.*"⁵⁹

As noted above, the hearing record contains no evidence that Turbeville and Kline gave any meaningful thought to effective duration – or any other measure of interest rate risk – in connection with constructing their customers' CMO portfolios.⁶⁰ Without this type of information, it was impossible for Turbeville and Kline to fully comprehend the degree of risk in their customers' accounts. Yet they argued to the Hearing Panel that they apprised their customers of all pertinent risks, and that these customers – none of whom had any expertise in financial products – understood and accepted those risks. If Turbeville and Kline did not even avail themselves of the most basic tool for appreciating the interest rate risk in the customers' portfolios, there is no way for them to have conveyed that risk to their customers.

⁵⁷ NASD Conduct Rule 2310(a).

⁵⁸ See *DOE v. Frankfort*, 2007 NASD Discip. LEXIS 16 (NAC, May 2007) (Delivery of a PPM does not negate liability for oral misstatements or omissions); *Robert A. Foster*, 51 S.E.C. 1211, 1213 n.2 (1994) (Notwithstanding the broker's distribution of prospectuses disclosing the risks associated with securities, he was liable for making material misstatements and omissions. "As the Commission has long held, information contained in prospectuses 'furnishes the background against which the salesman's representations may be tested. Those who sell securities by means of representations inconsistent with it do so at their peril.'") (Order Instituting Proceedings, Making Findings and Imposing Sanctions) (quoting *Ross Secs., Inc.*, 41 S.E.C. 509, 510 (1963)); See also *Larry Ira Klein*, 52 S.E.C. 1030, 1036 (1996) (Broker's delivery of a prospectus to a customer did "not excuse his failure to inform her fully of the risks of the investment package he proposed.").

⁵⁹ *DOE v. James B. Chase*, No. C8A990081 (NAC Aug. 15, 2001) (emphasis added).

⁶⁰ Tr. 2521-2525 (R-005085-005089).

Respondents' "written risk disclosure" identified some general characteristics of CMOs, but did not address the particular risks of the trading methods that Turbeville and Kline used. As DOE demonstrated at the hearing, those trading methods resulted in investment portfolios that had much greater overall levels of interest rate risk than individual CMOs.⁶¹ That fact was never disclosed to the customers. Respondents did not perform or obtain any calculation of effective duration.⁶² Without obtaining information essential understanding how much risk their trading methods had created, how could Respondents have disclosed the pertinent risks to their customers?

II. THE HEARING PANEL CORRECTLY FOUND THAT BROOKSTONE, TURBEVILLE AND KLINE MADE FRAUDULENT MISREPRESENTATIONS AND OMISSIONS IN CONNECTION WITH THEIR CMO SALES TO CUSTOMERS.

Respondents do not challenge the Hearing Panel's findings that they made misrepresentations and omitted to disclose facts in connection with their offers and sales of CMOs to their customers. They argue instead that the Hearing Panel lacked support for its findings that Turbeville and Kline acted with scienter. They also argue that their oral and implied misrepresentations and omissions were immaterial as a result of generic risk disclosures that they provided to customers. Respondents do not address their written misrepresentations to customers at all.

A. BROOKSTONE, TURBEVILLE, AND KLINE ACTED WITH SCIENTER.

The record is replete with support for the Hearing Panel's findings that Respondents acted with scienter. Their fraudulent statements and omissions were made over the course of two years to induce the seven elderly and retired customers to make unsuitable CMO investments and

⁶¹ Fong report, at 19-20 (R-000808-000809).

⁶² Tr. 2521-22, 3240-41 (R-005085-005086, 006010-006011).

to lull the customers into staying the course when they began to realize that their retirement funds were being depleted. Even though the rising interest rate environment persisted throughout the relevant time period (July 2005 to July 2007), and, as a result, IF CMOs continued to decline in value, Respondents were unrelenting in their recommendations to customers that they invest in CMOs.

This was not mere negligence, but a sustained, intentional campaign by Respondents to enrich themselves at the expense of elderly, retired customers. Plainly, Respondents actions demonstrated "a mental state embracing intent to deceive, manipulate or defraud."⁶³

B. RESPONDENTS' BRIEF MISSTATES THE LAW REGARDING THE EFFECT OF DISCLOSURES ON FRAUDULENT STATEMENTS AND OMISSIONS.

In their brief, Respondents contend that the false statements and omissions by Turbeville and Kline concerning their CMO strategy are "immaterial."⁶⁴ According to Respondents, Turbeville and Kline insulated themselves from any liability for fraud by giving the customers general disclosure documents that listed some risks that were common to CMOs.⁶⁵ Respondents cite three cases in support of this proposition. None of the three even remotely supports Respondents' interpretation.

*In re Westcap Enterprises*⁶⁶ involved the purchase of CMOs by a consortium of community colleges. The consortium claimed that Westcap made material misrepresentations and omissions to the consortium's treasurer concerning the effect of interest rates on CMOs. The

⁶³ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

⁶⁴ Respondents' Br. at 2.

⁶⁵ See CX-6, at 15 (R-006497), and other documents referenced on page 2 of Respondents' Brief: (CX-19 at 5 (R-006787); CX-30 at 7 (R-007129); CX-33 at 11 (R-007167); RX-13 at 9 (R-024828); CX-58 at 7 (R-008575); CX-66 at 8 (R-008864); CX-104 at 7 (R-009877) and CX-179 at 8 (R-010926).

⁶⁶ 230 F.3d 717 (5th Cir. 2000).

treasurer had managed the consortium's investment portfolio for many years,⁶⁷ held a doctorate degree with a focus on finance,⁶⁸ had access to the Bloomberg system in his office,⁶⁹ and had previously purchased tens of millions of dollars' worth of CMOs for the consortium.⁷⁰ The court rejected the consortium's fraudulent misrepresentation claim because, it found, any such misrepresentations or omissions regarding CMO risks were not material to the consortium, given its extensive knowledge of information that was pertinent to the investment decision.

The court did not, as Respondents suggest, reject the claim merely because written risk disclosures were available to the consortium. The critical issue for the court was the relative knowledge of the sellers and the buyers: the treasurer and the consortium's directors "knew the overall size of [the consortium's] portfolio and the percent of that portfolio held in [mortgage-backed securities],"⁷¹ whereas Westcap did not. This disparity in knowledge and expertise is the critical fact in the *Westcap* decision. In its conclusion, the Court of Appeals stated:

... given this superior knowledge on the part of [the treasurer] and his superiors concerning the risk of these securities in proportion to the size and purpose of [the consortium's] portfolio, any omission on the part of Westcap about the risk of and magnitude of purchases made in the fall of 1993 simply could not have been material to investment decisions that were made.⁷²

At no point does the *Westcap* decision state or suggest that a written risk disclosure trumps "any contrary oral or implied representation," as Respondents assert in their brief.⁷³

⁶⁷ *Id.* at 720.

⁶⁸ *Id.* at 722.

⁶⁹ *Id.* at 730.

⁷⁰ *Id.* at 720.

⁷¹ *Id.* at 732.

⁷² *Id.* at 732-33.

⁷³ Respondents' Br., at 2.

The record in this case shows that Turbeville and Kline had vastly more knowledge of and information about CMOs and their particular CMO-trading strategy than their customers did. Turbeville and Kline knew the size and contents of their customers' portfolios before their customers did, and they knew the contents of those portfolios in much greater detail. Their customers were ordinary individual investors who had never managed portfolios worth hundreds of millions of dollars, who did not have Bloomberg terminals in their offices, and, with one exception, who had not previously invested in CMOs. In no sense is *Westcap* instructive here, except as an example of the type of sophisticated institutional investor that might be equipped to appreciate and weigh the risks of investing in CMOs.

The citation to *Banca Cremi, S.A. v. Alex Brown & Sons, Inc.*,⁷⁴ is similarly misguided. The customer in that case was a Mexican bank with approximately \$5 billion in assets.⁷⁵ An Alex Brown representative recommended CMOs to the bank and the bank ultimately purchased \$40 million worth of CMOs.⁷⁶ After the investments lost approximately half of their value, the bank sued Alex Brown for securities fraud.⁷⁷ Both the district court and the U.S. Court of Appeals for the Fourth Circuit rejected the bank's claim that it justifiably relied on misstatements or omissions by Alex Brown concerning the risks of investing in CMOs.⁷⁸

As in *Westcap*, the court of appeals examined the respective knowledge of the investor and the broker to determine whether the broker's misrepresentations or omissions regarding CMOs were material. The court found that the bank was a sophisticated institutional investor.⁷⁹ It

⁷⁴ 132 F.3d 1017 (4th Cir. 1991).

⁷⁵ *Id.* at 1023-24.

⁷⁶ *Id.* at 1026.

⁷⁷ *Id.*

⁷⁸ *Id.* at 1027.

⁷⁹ *Id.* at 1029.

also noted that the bank conducted independent research on CMOs, including consulting with other brokerage houses, and that it consulted with “a leading CMO expert and finance professor,” Frank J. Fabozzi.⁸⁰ In short, there was no deficit of information or understanding by the bank, relative to the broker, and thus no basis for relying on statements by the broker that were contrary to what the bank already knew and understood about CMO-related risks. “As a sophisticated business entity handling five billion dollars of other people’s money, the Bank had the advice of its own employees and a horde of the defendants’ competitors.”⁸¹

Again, there is no comparison between the customer in *Banca Cremi* and the customers in this case. Here, it was Turbeville and Kline who had the overwhelming advantage in knowledge and access to information. It was Turbeville – not any of his customers – who claims to have consulted with “CMO expert” Frank Fabozzi, whom Turbeville described as “by far the leading expert on these securities.”⁸² It was Turbeville and Kline, not their customers, who managed large amounts of other people’s money.⁸³ Given this disparity in knowledge and understanding of the pertinent facts affecting the customers’ CMO portfolios, Turbeville and Kline’s misstatements and omissions concerning the risks of their CMO strategy were material.

The third case that Respondents cite for the bogus proposition that a written risk disclosure trumps any oral misrepresentation or omission to the contrary is *Brown v. E.F. Hutton Group, Inc.*⁸⁴ That case involved the sale of a single security – an oil-and-gas limited partnership – to several hundred investors. The Court of Appeals for the Second Circuit held that the broker’s misrepresentations were not material because the investors had received a prospectus

⁸⁰ *Id.* at 1024-25, 1029.

⁸¹ *Id.* at 1031.

⁸² Tr. 1735-36 (R-004297-004298).

⁸³ Tr. 1755-56 (R-004317-004318).

⁸⁴ 991 F.2d 1020 (2d Cir. 1993).

that contained a detailed description of the risks associated with the investment.⁸⁵ The *Brown* court, however, made a point of specifically and preemptively rejecting the position that Respondents have taken here, stating that “information or representations outside of the Prospectus may be material and justify reliance.”⁸⁶ It went on to say:

As stated by the Tenth Circuit in *Zobrist*, ‘we do not imply that the defendants can disclaim responsibility for their misrepresentations simply by disclosing the risks in the memorandum and therein warning investors not to rely on representations not contained within the memorandum.’⁸⁷

That, of course, is exactly what Respondents are trying to do here – disclaim responsibility for their misrepresentations and omissions on the grounds that customers received perfunctory written disclosures.

III. THE HEARING PANEL’S WITNESS CREDIBILITY DETERMINATIONS AND EVIDENTIARY RULINGS WERE PROPER.

Respondents concede that credibility determinations of an initial fact-finder, which are based on hearing the witnesses’ testimony and observing their demeanor, are entitled to considerable weight and deference.⁸⁸ Respondents also acknowledge that a Hearing Panel’s credibility determinations can be overcome only where the record contains “substantial evidence” for doing so.⁸⁹ Respondents have failed to show substantial evidence – or any evidence – that would support disturbing the Hearing Panel’s credibility determinations.

⁸⁵ *Id.* at 1031-32.

⁸⁶ *Id.* at 1033 n.4.

⁸⁷ *Id.*

⁸⁸ *Kelth L. DeSanto*, 52 S.E.C. 316, 319 (1995), *aff’d*, 101 F.3d 100 (2d Cir. 1996).

⁸⁹ *Anthony Tricarico*, 51 S.E.C. 457, 460 (1993). See also, *Dep’t of Enforcement v. Mizenko*, Complaint No. C8B030012, 2004 NASD Discip. LEXIS 20, at *16 n.11 (NAC Dec. 21, 2004), *aff’d*, Exchange Act Rel. No. 52600, 2005 SEC LEXIS 2655 (Oct. 13, 2005).

Respondents challenge the Hearing Panel's credibility findings on various grounds. They argue, for example, that it was improper for the Hearing Panel to credit customer testimony and declarations solely because the testimony or declarations were consistent with the testimony or declarations of other customers; that certain witnesses' testimony is unreliable because they could not recall particular facts; and that certain witnesses' hearing testimony was inconsistent with prior statements.

Respondents also claim that the Hearing Panel erred both by permitting the sons of Customers ~~G...~~ and ~~P...~~ to testify and by admitting Customer ~~B...~~ video testimony into evidence.

None of this constitutes grounds for rejecting the Hearing Panel's credibility determinations, particularly where, as here, the hearing record is brimming with support for those determinations. As the basis for finding the customer testimony evidence credible, the Hearing Panel cites, among other things, the fact that the customers in this matter do not know each other, yet they all testified consistently regarding Turbeville's and Kline's misrepresentations and omissions; that the Hearing Panel observed the demeanor of the testifying witnesses and found them to be credible; and that the written customer declarations were consistent with the record evidence and with testimony from witnesses who appeared at the hearing.⁹⁰ There is no basis for finding that the Hearing Panel's credibility determinations based on these factors were improper.⁹¹

⁹⁰ See Decision at 24, 27, 29, 33, 36, 37, 40 (R-038566, 038569, 038571, 038575, 038578, 038579, 038582).

⁹¹ *Department of Market Regulation v. Marshall J. Field*, No. CMS040202, 2008 FINRA Discip. LEXIS 63, at *22-25 (NAC Sept. 23, 2008) (finding that although some elderly customers may have been mistaken with respect to each and every detail, the customers' testimony was candid, supported in certain instances by written notes, and consistent. Accordingly, the testimony was properly credited by the Hearing Panel); *Anthony Tricarico*, 51 S.E.C. 457, 461 (1993) (refusing to overturn adjudicator's credibility determination of witness who was unable to recall certain details even though respondent had identified certain inconsistencies in witness's testimony); *Alvin W Gebhart*, Exchange Act Rel. No. 53136, 2006 SEC LEXIS 93, at *19 n.18 (Jan. 18, 2006) (holding that similarities among investors' testimony strengthens the reliability of that testimony), *rev'd in part and remanded on other*

In addition to their general complaints, Respondents attack the credibility of each witness. The attacks on R's credibility illustrate their flawed reasoning. According to Respondents, the Hearing Panel erred in deeming R to be unsophisticated because after years of working as a mobile home salesman and owning and operating car washes and convenience stores, R and his wife had amassed a comfortable retirement savings. Respondents point to no authority to support their assertion that these facts alone make R a sophisticated investor. Moreover, Respondents do not identify any evidence that contradicts the finding that R was financially unsophisticated.

Respondents also complain that R's testimony should have been rejected because R and his wife signed a declaration prepared by Turbeville. The declaration contradicts R's testimony at the hearing and a sworn declaration that R signed and submitted to FINRA. R and his wife testified at the hearing that they did not want to sign the declaration, but that they did so because they were concerned about accounts that they still had with Brookstone and because they felt pressured by Turbeville.⁹²

Regardless, other evidence in the record corroborates R's testimony about his own background and about Turbeville's misrepresentations and omissions regarding CMOs. Most notable is a *Financial Profile*⁹³ that Turbeville prepared for R at the outset of their relationship. In that document, Turbeville acknowledged that "preservation of your principal" was one of R's primary concerns, which is consistent with R's hearing testimony.⁹⁴ In the

grounds, 255 F. App'x 254 (9th Cir. 2007). See also, *Harry Gliksman*, 54 S.E.C. 471, 480-81 (1999) (finding customer affidavit, corroborated by FINRA examiner's testimony regarding his conversations with the customer, was admissible because it was probative and reliable), *aff'd*, 24 F. App'x 702 (9th Cir. 2001).

⁹² Tr. 581-582 (R-002564-002565).

⁹³ CX-337 (R-013755-013768).

⁹⁴ *Id.* at 10.

Financial Profile, Turbeville also recommended the CMO strategy as a way to "provide stability of principal," a return of 10% "with a high degree of predictability."⁹⁵ There were no disclosures in the *Financial Profile* regarding the risks associated with investing in CMOs, nor of the magnified risk that comes with doing so on margin. From beginning to end, the *Financial Profile* confirms the candor of R's testimony regarding his risk tolerance, his investment objectives, and Turbeville's statements regarding CMO trading.

According to Respondents, it was improper for the Hearing Panel to permit the sons of Customers P and G to testify. It is well-established that hearsay evidence is permissible in FINRA disciplinary proceedings.⁹⁶ And a third party may be allowed to testify concerning an unavailable customer witness if the third party's testimony is probative and reliable.⁹⁷ Here, both sons had firsthand knowledge of their mothers' dealings with Respondents.

P's son, R P,⁹⁸ was also a client of Brookstone and Kline, and had invested in CMOs based on Kline's recommendations. R P testified that he was present when P established her account with Kline,⁹⁹ that he knew that P had no investment knowledge,¹⁰⁰

⁹⁵ *Id.* at 12.

⁹⁶ See *Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217 at *46-47 (SEC Jan. 30, 2009) (stating that "it is well-established that hearsay evidence is admissible in administrative proceedings and can provide the basis for findings of violation, regardless of whether the declarants testify"); see also *Otto v. SEC*, 253 F.3d 960, 966 (7th Cir. 2001) (stating that "it is well established that hearsay evidence is admissible in administrative proceedings, if it is deemed relevant and material").

⁹⁷ See *Edgar B. Alacan*, Securities Act Rel. No. 8436, Exchange Act. Rel. No 43370, 2004 SEC Lexis 1422, at *23-24 (July 6, 2004) (claim of fundamental unfairness and denial of due process because testimony of relatives of customers (son-in-law permitted to testify on behalf of mentally and physically frail father-in-law, and wife testified on behalf of husband in his 90s who had dementia) was permitted, was rejected based on findings that relatives' testimony was probative and reliable).

⁹⁸ Notwithstanding Respondents claim to the contrary (Respondent's Br. at 14), R. Pasco was on DOE's witness list. (R-001610).

⁹⁹ Tr. 250 (R-002234).

¹⁰⁰ Tr. 274 (R-002258).

that he had personally seen the pre-populated new account documents that Kline sent to P[REDACTED] for her signature,¹⁰¹ and that he had conducted his own investigation of the activity in P[REDACTED]'s accounts.¹⁰² Clearly, this testimony was probative of issues in the case. After observing his demeanor at the hearing and reviewing corroborative documents, the Hearing Panel deemed P[REDACTED]'s testimony to be credible.

G[REDACTED]'s son, John G[REDACTED], testified that G[REDACTED] had limited investment experience,¹⁰³ that it was not G[REDACTED]'s handwriting on new account forms sent to her by Kline,¹⁰⁴ and that G[REDACTED]'s primary investment objective was to preserve her capital.¹⁰⁵ He also testified that he had personally reconstructed the activity in his mother's accounts and, upon realizing the high-risk nature of the investments in her accounts, had ordered Kline to cease all purchase activities in the accounts.¹⁰⁶ The Hearing Panel properly deemed John G[REDACTED]'s testimony both probative and reliable.

A. THE HEARING OFFICER CORRECTLY DENIED RESPONDENTS' REQUEST TO REQUIRE FINRA TO SWEEP THE TEN LARGEST CLEARING FIRMS IN THE SECURITIES INDUSTRY FOR DOCUMENTS THAT MIGHT OR MIGHT NOT EXIST¹⁰⁷

Respondents claim that they were denied a full and fair hearing because the Hearing Officer would not allow them to engage in a fishing expedition for potential documents. By

¹⁰¹ Tr. 276 (R-002260).

¹⁰² Tr. 267 (R-002251).

¹⁰³ Tr. 694 (R-002678).

¹⁰⁴ Tr. 710 (R-002694).

¹⁰⁵ Tr. 718-719 (R-002702-002703).

¹⁰⁶ Tr. 696-701, 706-707, 725, 727-728 (R-002680-002685, 002690-002691, 002709, 002711-002712).

¹⁰⁷ Respondents also complained that the Hearing Officer improperly excluded Respondents' expert witness. Two expert witnesses (Sub[REDACTED] and MacLaver[REDACTED]) testified on Respondents' behalf at the hearing. MacLaver[REDACTED] testified about the suitability of the CMO transactions at issue in this matter. *Decision* at 11-13 (R-038553-038555).

motion dated February 28, 2011, Respondents sought to have DOE issue Rule 8210 requests:

... to the ten largest FINRA clearing firms seeking documentation for brokerage accounts related to any of the identified client. The Rule 8210 requests would seek (1) all new account documents for the identified clients and (2) all monthly account statements from January 1, 2001 to the present date.

The Hearing Officer properly denied Respondents' motion.¹⁰⁸ Additional information about the customers' investment experience from before they entrusted their respective lives' savings to Respondents would not change the critical facts of this case. Moreover, such information is ultimately irrelevant to this proceeding for two reasons.

First, to the extent that historical information about a customer's investment experience differs from what Turbeville and Kline knew when they made their recommendations, it could not change the outcome of suitability determinations that the Respondents were supposed to have made from 2005 to 2007. What matters for purposes of a broker's obligation under the suitability rule are "the facts, if any, *disclosed by the customer* as to his or her other security holdings and financial situation and needs."¹⁰⁹ In other words, whether Turbeville and Kline had reasonable grounds for believing that high concentrations of IFs were suitable for their customers from July 2005 through July 2007 depends on what they knew about the customers during that time period. Information that comes to light after a registered representative makes a recommendation cannot make the recommendation unsuitable after the fact. Likewise, under no

¹⁰⁸ The Hearing Officer correctly ruled that "in cases such as this, where excessive trading is not alleged, and control is not at issue (because the Respondents concede that they exercised discretion in the customers' accounts), "Information about a customer's trading activity at other broker-dealers is irrelevant. What matters is the suitability of the trades at issue." *Order Denying Respondents' Motion to Order Enforcement to Issue Requests for Information Pursuant to Rule 8210* (Apr. 12, 2011), quoting *DOE v. Medeck*, No. E9B2003033701, 2009 *FINRA Discp. LEXIS 7*, at *53-43 (NAC Jul. 30, 2009).

¹⁰⁹ NASD Rule 2310 (emphasis added).

circumstances could subsequent information – the Respondents sought to obtain these documents in 2011 – make the 2005-2007 transactions retroactively suitable.¹¹⁰

Second, the ostensible explanation for why Respondents needed account records from other broker-dealers – to corroborate the validity of the “aggressive income” investment-objective designation in the customers’ new account forms¹¹¹ – could never cure the problems that they created by constructing such high-risk portfolios. As discussed above, Brookstone’s own documents identified investment products that were typically purchased by investors with an “aggressive income” objective, and inverse floater CMOs were much riskier than those investment products. Thus, even if Respondents had obtained evidence proving that all seven of the elderly and retired customers sought “aggressive income,” the level of risk that Turbeville and Kline placed into the customers’ portfolios would still have been grossly excessive.¹¹²

¹¹⁰ It should be noted that Respondents had access to much of the information that they sought to have DOE request pursuant to Rule 8210. Notwithstanding their assertion that DOE adduced only a “scant” amount of information about the customers at the hearing, a significant amount of information about the customers’ prior investment accounts was admitted into evidence. For example, records for accounts that customer Baker had at two prior securities firms during the period from April 2001 to April 2005 were admitted into evidence; records for accounts that customer P... had at two prior securities firms during the period from April 2003 to December 2005 were admitted into evidence; records for accounts that customer Carter had at a prior securities firm during the period from Jan 2004 to May 2005 were admitted into evidence; records for accounts that customer G... had at a prior securities firm during the period from May 2002 to April 2005 were admitted into evidence; records for accounts that customer P... had at three prior securities firms from January 2001 to at least April 2005 were admitted into evidence; and records for accounts that customer R... had at a prior securities firm during the period from Jan 2004 to April 2005 were admitted into evidence. In addition to the account documents admitted into evidence at the hearing, numerous other customer account records were tendered to Respondents during discovery. See R-001249-001256 - (*Attachment A to Department of Enforcement’s Opposition to Respondents’ Motion for Production of Documents and Information Pursuant to Rule 9252*). Even with a wealth of information about the customers at their deporal, Respondents were unable to demonstrate that the customers were the savvy, risk-seeking investors that Respondents have portrayed them to be.

¹¹¹ According to Respondents’ brief, “documents, such as new account forms from other firms . . . would have demonstrated that the account documentation at Brookstone was consistent with the forms at those other firms.” Respondents’ Br., at 8.

¹¹² There were several other problems with Respondents’ critique of the Hearing Officer’s denial of their Motion. Among those shortcomings, which the Hearing Officer fully addressed in her Order denying the motion, was the unreasonable basis for and overly broad scope of the motion. Respondents sought to have DOE obtain *ten years’* worth of account documents from each of the *ten largest FINRA-regulated clearing firms*. Respondents identified no basis for expecting these firms to have account records for any of the customers at issue in the case, only the supposedly significant possibility that one or more of them might. The Hearing Officer rightly described Respondents’ Motion as a fishing expedition.

When Respondents tried to rehash the issues raised in their Motion during their opening statement at the hearing, the Hearing Officer rightly ruled that the information sought was irrelevant and ordered Respondents to move on from that discussion.¹¹³

IV. THE RECORD FULLY SUPPORTS FINDINGS THAT LOCY FAILED TO ADEQUATELY SUPERVISE TURBEVILLE'S AND KLINE'S CMO TRANSACTIONS AND THAT HE FAILED TO SUPERVISE DISCRETIONARY ACCOUNTS AND TRANSACTIONS.

Regarding Locy's failures to supervise Turbeville's and Kline's offers and sales of CMOs to Brookstone customers, Respondents assert only that supervisory violations are necessarily derivative of a primary violation, and that because the CMO transactions at issue in this matter were suitable, there can be no failure to supervise. This argument is plainly wrong, as there can be supervisory failures even absent finding of a primary violation.¹¹⁴ Further, the primary violation at issue – the recommendation of unsuitable investments – is well proved.

More importantly, the record evidence supports the conclusion that Locy failed in every conceivable way to supervise the CMO transactions at Brookstone. Although Respondents claim a lack of evidence to support the finding that Locy failed to adequately review discretionary accounts, Locy admitted that he did not review discretionary accounts at frequent intervals as contemplated by NASD Rule 2510(c).¹¹⁵ At the hearing, he stated that his discretionary account review consisted of random monthly account reviews that may or may not have included

¹¹³ Tr. 32-33 (R-002016-002017).

¹¹⁴ "A determination that a respondent has violated NASD's supervisory rule is not dependent on a finding of a violation by those subject to the respondent's supervision." *Robert J. Prager*, Exchange Act Rel. No. 51974 (July 6, 2005), 85 SEC Docket 3413, 3432-33 & n.52 (citing NASD Notice to Members 98-96 (Dec. 1998) (stating that a violation of Rule 3010 can occur in the absence of an underlying rule violation)).

¹¹⁵ Tr. 2470-71, 2475-76 (R-005034-005035,005039-005040).

discretionary accounts.¹¹⁶ Locy also admitted that he had no specific recollection and no record of having contacted any customers to determine their level of satisfaction, although required by the written supervisory procedures that he helped draft.¹¹⁷ **The Hearing Panel's Sanctions Should Be Affirmed**

The record evidence fully supports the Hearing Panel's findings of egregious misconduct by Respondents. Accordingly, the sanctions imposed against Respondents should be left undisturbed.

The NAC should also affirm the Hearing Panel's restitution order. SEC and FINRA policy strongly favor the payment of restitution where a customer has suffered identifiable losses resulting from a broker's misconduct. The SEC has held:

Restitution — a traditional remedy used to restore the status quo where otherwise a wrongdoer would unjustly benefit or his victim would unjustly suffer loss — is a particularly fitting sanction in cases of unsuitable recommendations. In the related context of disgorgement, we have encouraged the NASD to use its remedial powers to return to investors funds lost in cases where, as here, a professional has acquired a benefit by failing to meet his obligations. . . . As between [the customer], who was placed in an unsuitable investment and [the broker], who recommended it, equity *requires* [the broker], as the person responsible for the loss, to bear its burden and to return the customer to the position occupied prior to the improper recommendation.¹¹⁸

To restore the status quo *ante*, Respondents should, as the Hearing Panel ordered, pay the customers restitution in amounts that will compensate their trading losses.

¹¹⁶ Tr. 2453-2459 (R-005017-005023).

¹¹⁷ Tr. 2493, 2513 (R-005057, 005077).

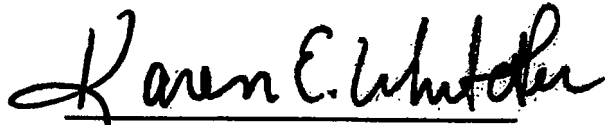
¹¹⁸ *David J. Dambro*, 1993 SEC LEXIS 1521, at *14 (June 18, 1993) (emphasis added). See also General Principle No. 5, *Sanction Guidelines* at 4; *NASD Notice to Members 99-86*, 1999 NASD LEXIS 63, at *2, entitled, "NASD Regulation Adopts Policy Regarding Imposition and Collection of Monetary Sanctions" (October 1999). Restitution is routinely ordered in cases involving identifiable customer losses. See, e.g., *DOE v. Faber*, CAF010009, 2003 NASD Discp. LEXIS 3, at *41 (NAC May 7, 2003 (restitution ordered where customers suffered quantifiable loss as a result of Respondent's misconduct), *aff'd* 2004 SEC LEXIS 277 (Feb. 10, 2004); *DOE v. Douglas*, No. C10000026, 2002 NASD Discp. LEXIS 3, at *19 (NAC March 25, 2002) (affirming restitution order "because the customers' losses are quantified").

CONCLUSION

For the foregoing reasons, the Hearing Panel's decision should be affirmed in all respects.

Respectfully submitted,

Dated: November 29, 2012



Karen E. Whitaker, Senior Regional Counsel
FINRA Department of Enforcement
12801 North Central Expressway, Ste. 1050
Dallas, TX 75243
972/716-7610 (voice)
972/716-76512 (fax)
karen.whitaker@finra.org

Adam B. Walker, Principal Regional Counsel
FINRA Department of Enforcement
120 West 12th Street, Suite 800
Kansas City, MO 64105
816/802-4751 (voice)
816/421-4519 (fax)
adam.b.walker@finra.org

Appendix A

RESPONDENTS' BACKGROUNDS AND DISCIPLINARY HISTORIES

Brookstone Securities, Inc. was, during all times relevant hereto, a member of FINRA and registered as a broker-dealer with the U.S. Securities and Exchange Commission. Brookstone purchased predecessor broker-dealer RISE, Inc. on July 14, 2005.¹ RISE, Inc. had been a member of FINRA since April 8, 1983.² Brookstone filed a Form BDW (Broker/Dealer Withdrawal) on June 20, 2012, seeking to withdraw from FINRA membership. As described below, the firm was subsequently expelled from FINRA membership in October 2012 for its failure to pay fines assessed in connection with two disciplinary actions. Brookstone's disciplinary history includes the following:

On September 27, 2011, FINRA issued an Order Accepting Offer of Settlement (No. 2009017275301) in which Brookstone was censured and fined \$200,000 for willful violations of Section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 thereunder, NASD Rules 2110, 2120, 3010(a) and 3010(b), and FINRA Rules 2010 and 2020. Turbeville and Locy were each fined \$10,000 and suspended from association with any FINRA member firm in any principal capacity for three months. The Respondents agreed to findings that the firm, acting through registered representatives, made misrepresentations and/or omissions of material fact, provided unwarranted price predictions to customers; made guarantees against loss to customers, failed to disclose certain risks to customers, made unsuitable investment recommendations, exercised discretion in customer accounts without prior written authorization or acceptance of the accounts as discretionary by Brookstone. Additionally, Brookstone, acting through its

¹ CX-1 at 6 (R-006366).

² CX-1 at 3 (R-006363).

chief executive officer and its president, failed to reasonably supervise a registered representative, failed to follow up on red flags, and failed to establish, maintain and enforce supervisory procedures reasonably designed to achieve compliance with respect to the above-described violations.

On August 8, 2011, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2009016158302) in which Brookstone was censured and fined \$15,000 for violations of Article V, Sections 2 and 3 of FINRA's By-Laws, FINRA Rules 1122 and 2010, NASD Rule 3070 and IM 1000-1. The firm agreed to findings that it failed to update or timely update Forms U4 and U5 with required information, and provided inadequate information in connection with Rule 3070 filings. On October 17, 2012, FINRA expelled the firm from membership for its failure to pay the \$15,000 fine.

On May 23, 2011, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2009019837303) in which Brookstone was fined \$25,000, jointly and severally, with Locy, for violations of NASD Rules 2110 and 3010 and FINRA Rule 2010. The respondents agreed to findings that the firm, acting through Locy, had no written supervisory procedures addressing due diligence requirements for third-party private placements, and had failed to conduct adequate due diligence of a third-party private placement offerings before approving the offering for sale to firm customers. On October 9, 2012, FINRA expelled the firm from membership for its failure to pay the \$25,000 fine.

On April 30, 2010, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2008011675701) in which Brookstone was censured and fined \$17,500 for violations of SEC Rules 17a-3(a), 17a-3(a)(18) and 17a-4, 17a-4(b)(1), Article V, Section 2 of the FINRA By-Laws, and NASD Rules 2110, 3010(a)(7), 3070, 3110(d) and 6230.

The firm agreed to findings that it had failed to ensure that all of its registered personnel participated in the firm's annual compliance meeting; failed to timely update a registered representative's Form U4 to disclose required information; failed to timely disclose two customers complaints; failed to report five quarterly statistical customer complaints; failed to create and maintain a record of customers' complaint or, alternatively, failed to maintain a separate file that contained complainant's information; failed to report transactions to TRACE; and failed to evidence the creation and maintenance of order tickets for sell transactions in corporate bonds.³

Antony Lee Turbeville entered the securities industry in July 1987, when he associated with a FINRA member firm.⁴ He subsequently registered with 11 different member firms, including Kovack Securities, Inc. from July 2000 to May 2002; GunnAllen Financial, Inc. from May 2002 to April 2003; Archer Alexander Securities Corporation from April 2003 to April 2005; and Brookstone from April 2005 to June 2012. During the relevant time period, Turbeville served as a General Securities Principal and a Registered Representative with Brookstone.⁵ He was also the firm's Chairman of the Board, Chief Executive Officer, and at least a 75% owner of the firm.⁶ On June 20, 2012, a Form U5 was filed on Turbeville's behalf by Brookstone, terminating his registrations with that firm. During his career in the securities industry, Turbeville obtained Series 6, 7, 24 and 63 securities licenses.⁷ His disciplinary history includes the September 27, 2011 action noted above (AWC No. 2009017275301).

Christopher Dean Kline entered the securities industry in February 1995, when he

³ CX-1 at 20 (R-006380).

⁴ CX-4 at 21 (R-006465).

⁵ CX-4 at 4-9 (R-006453).

⁶ CX-1 at 6 (R-006366); CX-4 at 1 (R-006445).

⁷ CX-4 at 16 (R-006460).

associated with a FINRA member firm.⁸ He subsequently associated with six different member firms, including Kovack Securities, Inc. from April 2001 to May 2002; GunnAllen Financial, Inc. from May 2002 to April 2003; Archer Alexander Securities Corporation from April 2003 to April 2005; and Brookstone from April 2005 to June 2012. During the relevant time period, Kline was registered as a General Securities Representative with Brookstone.⁹ On June 12, 2012, a Form U5 was submitted on Kline's behalf, terminating his registrations with the firm. Currently, Kline is associated with Capstone Wealth Management Corp. as an Investment Advisor. During his career in the securities industry, Kline obtained Series 7, 63 and 65 securities licenses.¹⁰ Kline's disciplinary history includes the following:

On June 18, 2012, FINRA issued a Letter of Acceptance, Waiver and Consent (No. 2009016520001) in which Kline was fined \$77,523.67, including disgorgement of financial benefits of \$67,523.67, and suspended from association with any FINRA member in any capacity for nine months, for violations of NASD Rules 2110 and 3040. FINRA found that Kline engaged in, and received compensation from, private securities transactions, without notifying his member firm. He is currently serving his suspension.

David William Locy entered the securities industry in June 2003, when he associated with FINRA member firm Archer Alexander Securities Corporation from June 2003 to May 2005. He subsequently registered with Brookstone from June 2005 to July 2012.¹¹ During the relevant time period, Locy served as Brookstone's President, Chief Operating Officer, Chief Compliance Officer and Financial and Operations Principal.¹² On July 5, 2012, a Form U5 was filed on Locy's behalf, terminating his registrations with Brookstone. During his career in the

⁸ CX-2 at 7 (R-006395).

⁹ CX-2 at 4-7 (R-006392 -95).

¹⁰ CX-2 at 12 (R-006400).

¹¹ CX-3 at 5, 3 (R-006429, R-006427).

¹² CX-1 at 5 (R-006365).

securities industry, Locy obtained Series 4, 7, 24, 27, 53 and 63 securities licenses.¹³ On October 9, 2012, FINRA revoked Locy's registrations for his failure to pay the \$25,000 fine assessed in connection with AWC No. 2009019837303. His disciplinary history includes the following:

On July 23, 2012, FINRA issued an Order Accepting Offer of Settlement (No. 2009019070902), in which Locy was suspended in all principal capacities for three months and assessed a deferred monetary fine in the amount of \$5,000 for violations of FINRA Rule 2010 and NASD Rules 2110 and 3010(a). Locy, acting as Brookstone's President and the designated person responsible for ensuring the firm's compliance with regulatory requirements, failed to conduct reasonable due diligence regarding two private placement offerings for which Brookstone acted as a selling agent.

Locy's disciplinary history also includes the May 23rd and the September 27th actions (AWC Nos. 2009019837303 and 2009017275301, respectively) noted above.

¹³ CX-3 at 8 (R-006432).

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
NATIONAL ADJUDICATORY COUNCIL**

Department of Enforcement,

Complainant,

v.

Brookstone Securities, Inc.
(CRD No. 13366),

Antony Lee Turbeville
(CRD No. 1721014),

Christopher Dean Kline
(CRD No. 2597293) and

David William Locy
(CRD No. 4682865)

Respondents.

DISCIPLINARY PROCEEDING
No. 2007011413501

CERTIFICATE OF SERVICE

I hereby certify that on this 29th day of November, 2012, I caused one of Department of Enforcement's Brief to be sent to each of Respondents' counsel, via overnight delivery and electronic mail, as follows:

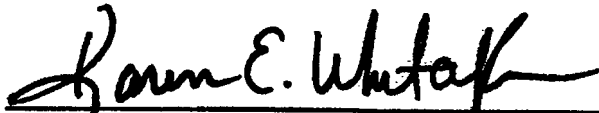
Alan M. Wolper, Esq.
Nathan W. Lamb, Esq.
Ulmer & Berne, LLP
500 W. Madison St., Ste. 3600
Chicago, Illinois 60661-4587
Email: awolper@ulmer.com and nlamb@ulmer.com.

James D. Sallah, Esq.
Joshua A. Katz, Esq.
Sallah & Cox, LLC
2101 NW Corporate Blvd., Ste. 218
Boca Raton, Florida 33431
Email: jds@sallahcox.com
Email: jkatz@sallahcox.com

Additionally, the original brief and one copy were also sent to the Office of General Counsel, via overnight delivery and electronic mail, as follows:

FINRA
Office of General Counsel
1735 K Street, NW
Washington, DC 20006-1500
Attn: Gary Dernelle
Email: nac.casefilings@finra.org

Respectfully submitted,



Karen E. Whitaker, Senior Regional Counsel
FINRA Department of Enforcement
12801 North Central Expressway, Suite 1050
Dallas, TX 75243
Ph: 972-716-7610; Fax: 972-716-7612
Email: karen.whitaker@finra.org and
judy.peters@finra.org (paralegal)

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
NATIONAL ADJUDICATORY COUNCIL**

Department of Enforcement,

Complainant,

v.

No. 20070011413501

Brookstone Securities (CRD No. 13366),
Antony Lee Turbeville (CRD No. 1721014),
Christopher Dean Kline (CRD No. 2597293) and
David William Locy (CRD No. 4682865)

Respondents.

REPLY IN SUPPORT OF APPEAL

Alan M. Wolper, Esq.
Nathan W. Lamb, Esq.
Ulmer & Berne, LLP
500 W. Madison St., Ste. 3600
Chicago, Illinois 60661-4587
Email: awolper@ulmer.com
Email: nlamb@ulmer.com

James. D. Sallah, Esq.
Joshua A. Katz, Esq.
Sallah & Cox, LLC
2101 NW Corporate Blvd., Ste. 218
Boca Raton, Florida 33431
Email: jds@sallahcox.com
Email: jkatz@sallahcox.com

Attorneys for Appellants

Dated: December 20, 2012

TABLE OF CONTENTS

I.	Introduction.....	1
II.	Argument	3
A.	The EHP's Credibility Decisions Are Unsupported By Substantial Evidence.....	3
B.	The EHP Denied Appellants Access To Evidence.	7
1.	The refusal to order the production of customer account records denied Appellants the opportunity to cross examine witnesses.	7
2.	DOE never addressed the undue prejudice of preventing Appellants from calling an expert on suitability and adequacy of disclosures, while accepting DOE's expert on the same issues.	8
C.	DOE's Legal Analysis Is Fatally Flawed.....	9
1.	The risk disclosures signed and initialed by the customers negates finding any alleged misrepresentation or omission was material.....	9
2.	The risk disclosures, based on NASD Notice to Members 93-73, were not mere boilerplate.	12
3.	DOE has failed to find a legal basis supporting a finding that Appellants engaged in intentional misconduct.....	12
III.	Conclusion	14

I. INTRODUCTION

In its opposition brief ("DOE Brief"), the Department of Enforcement ("DOE") has failed to address the fundamental arguments in Appellants' initial Brief concerning the overwhelmingly shocking questions concerning the fairness of the hearing. Instead, DOE has adopted a strategy of repeating the same, fundamentally flawed findings of the Extended Hearing Panel ("EHP") and refusing to address the actual issues raised by Appellants.

First, DOE fails to address the EHP's rulings on admissibility of evidence. Appellants do not dispute, and have never disputed, that hearsay evidence is permitted in disciplinary proceedings. The real issue is, however, how the EHP credited and relied on the testimony of (1) witnesses that flatly contradicted documentary evidence, such as the signed and initialed risk disclosure acknowledgements by customers and, in one case, an affidavit; (2) DOE's expert on suitability when he had never reviewed the customers' new account forms, signed and initialed disclosures or prior investment histories; and, (3) an examiner who drafted all of the supposedly consistent declarations of customers without reviewing the customers' investment histories.

Second, DOE has failed to address the wide variety of improper decisions made by the EHP in this case in refusing to allow Appellants the opportunity to present certain evidence. Appellants requested the opportunity to obtain customer account records through an 8210 request and present an expert on suitability. Both requests were refused. In its brief, DOE argues that the refusal to issue the 8210 requests was proper, because evidence of a customer's prior investment history would be irrelevant to determining whether the customers were sophisticated investors. This argument is, of course, ludicrous. Nevertheless, the refusal to allow Appellants access to this information prevented a fair opportunity to cross examine witnesses who all testified, not surprisingly, consistently that they were unsophisticated.

With regard to the exclusion of an expert witness on suitability, DOE presents no argument justifying the decision of the Hearing Officer (“HO”). Considering how the EHP specifically and expressly relied on DOE’s expert on suitability, while refusing to allow Appellants the opportunity to present contrary expert testimony, DOE’s silence emphasizes how fundamentally unfair this proceeding was.

Third, DOE’s arguments concerning the status of the law regarding risk disclosures is false and misleading. The law is well settled that “[a]n investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth.” *Ashland, Inc. v. Morgan Stanley & Co.*, 652 F.3d 333, 337-38 (2d Cir. 2011). When a defendant supplies risk disclosures to the customer, the defendant cannot be said to have misled the customer with regard to that risk. DOE has not confronted this legal proposition, but has argued, instead, that Appellants’ many risk disclosures, which were derived directly from NASD Notice to Members 93-73, were merely “general” disclosures.

Similarly, in their initial Brief, Appellants pointed out that the EHP’s findings of scienter were grossly deficient and lacked any legal (or factual) support. DOE has not provided any argument which would justify a finding of scienter. Instead, DOE asserts that this conduct was intentional merely because Appellants sold inverse floating CMOs at a time when interest rates were rising. At bottom, as Appellants did not understand effective duration (as DOE asserts the EHP found), then it would be impossible for Appellants to be found liable for intentionally omitting to disclose risks about which Appellants were themselves supposedly unaware. *See La. Pac. Corp. v. Money Mkt. 1 Institutional Inv. Dealer (In re: Merrill Lynch Auction Rate Secs. Litig.)*, 851 F. Supp. 2d 512, 539-40 (S.D.N.Y. 2012).

II. ARGUMENT

A. The EHP's Credibility Decisions Are Unsupported By Substantial Evidence.

The single factual finding that underlies the entire Decision is the EHP's conclusion that all of the customer witnesses were unsophisticated, and with low-risk tolerances. Clearly, the EHP recognized the necessity of this finding to its ultimate determination of liability, given the admonition in Notice to Members 93-73 that inverse floaters, a form of CMOs that these customers purchased, are "only suitable for sophisticated investors with a high-risk profile." Obviously, if the customers were, in fact, sophisticated, and were willing to accept high, not low, risks in their portfolios, DOE's case falls apart, completely, and the findings of liability would have to be reversed.

Not surprisingly, therefore, Appellants spent the majority of the evidentiary hearing challenging DOE's assertion that the customers were financial rubes, with no real histories of investing, seeking safety of principal, who were all somehow hoodwinked by Appellants (despite the multitude of written risk disclosures the record shows they were provided). As it turned out, the customer witnesses ended up making Appellants' job easy. Through their own testimony, they were proven to be forgetful, at best, and liars, at worst. Either way, the result was a dearth of any good, solid evidence in the record establishing that the customers were credible witnesses, as Appellants described in detail their initial Brief. There are many problems with DOE's scant response to Appellants' arguments regarding the long list of ill-founded credibility decisions that the EHP made.¹ Principally, however, it comes down to the reality that DOE never bothers to

¹ DOE appears to take umbrage at Appellants' decision to take issue with the EHP's credibility determinations, seemingly questioning Appellants' ability even to argue that the customers were not credible "in the face of the Hearing Panel's express credibility findings." DOE Brief at 2. DOE seems to miss the point: a hearing panel's credibility determinations are not unassailable. If there is "substantial evidence" establishing that the credibility determinations were erroneous – as Appellants insist is the case here – then those determinations may be deemed to be erroneous, and grounds for reversal.

address those facts that are most troublesome to it; rather, it focuses solely on the few matters for which it claims to have some answer.

A primary example is the sworn Affidavit that Mr. and Mrs. R executed, which substantially recants the Declaration, drafted by FINRA staff years earlier, on which the DOE, and the EHP, relied to make findings against Appellants. After *admitting* that the Affidavit “contradicts R[]’s testimony at the hearing and” the sworn Declaration (DOE Brief at 24) – which begs the question, *how can a witness contradict his own sworn testimony but still remain credible* – DOE cites to the testimony from Mr. and Mrs. R that they only signed the Affidavit “because they were concerned about accounts that they still had with Brookstone and because they felt pressured by Turbeville.” *Id.* What DOE fails to address at all,² however, is the un rebutted evidence in the record that at the time they signed the Affidavit, Mr. and Mrs. R *no longer had any accounts at Brookstone with anything other than token assets*. They could not, therefore, have had any realistic concerns about those accounts. Moreover, DOE fails to address the un rebutted fact that Mr. and Mrs. R insisted on having changes made to the Affidavit before they signed it, and that Mr. Turbeville readily agreed to their edits. How can such evidence possibly support the conclusion that Mr. and Mrs. R were “pressured” into signing the Affidavit? Simply put, it cannot.

DOE also defends its decision to call the offspring of two of the customers to testify, in lieu of the customers themselves, claiming it was not “improper.” *Id.* at 25. That argument is misplaced. It is not a matter of the children’s testimony being proper or improper; Appellants concede that hearsay testimony is “permissible in FINRA disciplinary hearings,”³ and was thus

² Notably, the EHP also failed to address this issue in the Decision. Like DOE, the EHP simply chose to ignore facts that did not fit neatly into its supposed analysis.

³ Repeatedly throughout its Brief, DOE cites cases for the proposition that hearsay testimony, or testimony adduced via affidavits or declarations, is “admissible.” *See, e.g.*, footnotes 91, 96 and 97 of DOE’s Brief. These

properly admitted into the record. *Id.* The question for the NAC, rather, is whether the EHP erred not by admitting that hearsay testimony but by *relying on it*, and finding it to be credible, given the two sons' admitted lack of personal knowledge of the facts underlying DOE's allegations.⁴

DOE also tries to make much of the fact that there was a certain degree of consistency among the testimony supplied by its customer witnesses, claiming that such consistency somehow serves to "strengthen[] the reliability of that testimony." *Id.* at 23 n. 91. This prompts two responses. First, it serves as DOE's concession, albeit a tacit one, that, absent that consistency, there is a real problem with the "strength" of their customer witnesses' testimony. Thus, the existence of consistency among the witnesses is critical to DOE's case.

Second, consistency alone means nothing. Given how FINRA went about acquiring its evidence, it is hardly a surprise that the witnesses' recollections all seemed to align. As Appellants pointed out at the hearing, as well as in their initial Brief, it was a single FINRA examiner who served as the sole point of contact with all the customer witnesses, and as the author of all the Declarations which constituted the basis for the critical findings in the Decision regarding suitability. The EHP hung its hat on the consistency among those Declarations, but, to do so, it had to ignore the clear (and dramatic) ramifications of the inconvenient fact that one particular customer's Declaration – that of LD – was utterly recanted. The EHP concluded, in

citations are all inapposite because Appellants do not contest DOE's right to introduce hearsay testimony. That would be foolish, given longstanding precedent permitting such evidence. What Appellants *do* contest is the EHP's determination to find DOE's hearsay evidence to be credible, and to use such evidence as the basis for its Decision. Just because something is admissible does not make it credible. DOE seems to have confused that concept, whether intentionally or not, in a transparently thin effort to avoid having the EHP's findings overturned.

⁴ DOE makes a fairly weak effort to try and show that the two sons in fact had personal knowledge of their respective parents' accounts, but it does not withstand analysis. Compare the few facts that these witnesses supposedly knew – DOE Brief at 25-26 – with the multitude of facts of which they admitted their ignorance. Appellants' Brief at 22-25.

light of this development, that his Declaration was worthless, so any claim relating to LD was deemed to be unproven. That was the correct decision, of course. But the EHP failed to consider how the utter inaccuracy of LD's Declaration also colored the reliability of the other customer Declarations. That is, if one customer – two, if you count Mr. and Mrs. R – admitted that the contents of the sworn Declaration that FINRA drafted were materially inaccurate, how can the contents of the other Declarations be accepted in blanket fashion due merely to the fact that they were “consistent” with one another? Had the EHP bothered to conduct the critical analysis outlined in Appellants' Brief, the other customer Declarations would have *also* been revealed to be shams, just like LD's and Mr. and Mrs. R's.

In summary, DOE's argument on the customer credibility issue is short on facts but long on hyperbole. For DOE to declare that Appellants supposedly failed to show not just “substantial evidence” but “*any* evidence . . . that would support disturbing the Hearing Panel's credibility determinations” (*Id.* at 22; emphasis supplied) in light of the obvious and serious problems with, for instance, Mr. and Mrs. R's testimony, the testimony of the sons of two of the customers, and the flawed deposition testimony of SB, underscores the problems that DOE faces here. *Ipse dixit* statements like this are the hallmark of advocates who lack the ability to make a true substantive argument in favor of their position. It has been said – accurately – about trial work is that when, as counsel, you have the facts on your side, you “pound the facts”; when you have the law on your side, you “pound the law.” But, when you have neither the facts nor the law on your side, you “pound the table.” DOE's Brief is, at its vacuous best, mere table pounding.

B. The EHP Denied Appellants Access To Evidence.

1. The refusal to order the production of customer account records denied Appellants the opportunity to cross examine witnesses.

DOE makes another erroneous argument in its Brief that also touches upon the credibility of its witnesses, as well as the propriety of the EHP's credibility determinations. It can be found in DOE's effort to justify the procedural/evidentiary rulings that the EHP made denying Appellants' requests to obtain the records of securities accounts that the customer witnesses maintained at other broker-dealers before coming to Brookstone. Those requests were designed, at least in theory, to enable Appellants potentially to contest DOE's assertion – an assertion for which DOE had the burden of proof, of course – that all the customers supposedly shared the same conservative investment objective, and that all customers were inexperienced and financially unsophisticated.⁵ The EHP denied the requests, however, supposedly because the information contained in such documents was not “relevant” to the “suitability of the trades at issue.” *Id.* at 27 n. 108.

The problem with this conclusion by the EHP, and, in turn, DOE's insistence that the EHP acted properly, is that it demonstrates the EHP's lack of appreciation for the fact that these documents would have also served as an important means of gauging the customer witnesses' credibility, regardless of whether they had any bearing on the suitability issue. If a customer swears in a Declaration that he lacks investment experience, for instance, or that he never invested in speculative securities, but those assertions are belied by documentary evidence demonstrating that the opposite is true, then such documentary evidence would undoubtedly be relevant, since they would go to the witness' credibility. Unfortunately, the EHP erroneously

⁵ In light of the fact that the EHP expressly agreed with these allegations by DOE, the importance of this evidence, and the significant impact that it could have had on the outcome of this case had Appellants been permitted to obtain it, cannot be overstated.

denied Appellants the opportunity even to make such arguments by foreclosing their efforts to obtain the pertinent documents.

Finally, DOE argues that even if the forbidden documents would, in fact, have demonstrated that the customer witnesses had sought “aggressive income” in their prior securities accounts, the EHP’s error in denying Appellants’ requests for these documents was still harmless, because the investments at issue were too risky even for customers with such an investment objective. *Id.* at 28. The record simply does not justify such a conclusion.

The only support DOE cites for its broad statement is a new account form that was used at Brookstone from 2005 – 2007 which listed several examples of investments that were appropriate for customers seeking “aggressive income.” *Id.* at 14-15. There is nothing in the record, however, that suggests, let alone establishes, that the investments included in that list were meant to be determinative, or exclusive. They were merely examples, not meant to be an exhaustive list. To claim that “aggressive income” investors were absolutely restricted *only* to the investments in the list is the sort of stretch that, while clever, is not ultimately logical, and therefore cannot sustain the EHP’s faulty decision.⁶

2. **DOE never addressed the undue prejudice of preventing Appellants from calling an expert on suitability and adequacy of disclosures, while accepting DOE’s expert on the same issues.**

One of the most egregious indications of misconduct on the part of the EHP concerned the refusal to permit Appellants the opportunity to present an expert witness on the issue of suitability and adequacy of disclosures. *See* Brief at 10-11. As Appellants pointed out, while claiming that this testimony would be duplicative of the expertise of the EHP, the EHP

⁶ DOE once again heralds Mr. Feng’s opinion that the investments at issue were more aggressive than an “aggressive income” objective would allow as a basis for its argument. Obviously, if, as argued elsewhere, Mr. Feng’s opinion is flawed because it was founded on the incorrect premise, i.e., that the customers all were conservative investors uninterested in aggressive income, then it cannot provide any legitimate support for DOE’s argument.

nevertheless allowed DOE to present expert testimony on the same subjects for which the HO refused to allow Appellants, namely, suitability and adequacy of disclosures. Shockingly, the EHP based its findings that the disclosures were inadequate and the recommendations were unsuitable based on DOE's expert's testimony.

In its brief, DOE has failed to provide any argument which would even remotely suggest that this decision preserved Appellants' right to a fundamentally fair hearing. There should be no dispute that this was unfair: The denial of one party to present expert testimony on the central subjects of this case, while allowing the opposing party the ability to call its own expert on the same subjects.

C. DOE's Legal Analysis Is Fatally Flawed.

1. The risk disclosures signed and initialed by the customers negates finding any alleged misrepresentation or omission was material.

Appellants argued in their initial brief that the disclosure documents the customers signed and initialed rendered any alleged misrepresentations or omissions immaterial as a matter of law. In its opposition, DOE attempts to distinguish the cases relied upon by Appellants, based on the supposed differences in investment knowledge between the customers in this case and the plaintiffs in the cases cited by Appellants.

DOE's argument is based on an assertion that Appellants were more knowledgeable about CMOs than their customers, who "were ordinary individual investors."⁷ DOE Brief at 20. Yet, the materiality of information is based on whether a reasonable investor would have the information as significantly altering the "total mix" of information available. *TSC Industries*,

⁷ In this regard, DOE is attempting to rewrite the law concerning prospectus delivery. DOE claims, for instance, that, where there is a disparity of knowledge between a broker and a customer, the content of the prospectus is irrelevant. DOE's approach would require a broker with so-called superior knowledge to second-guess a customer who has signed and initialed that the customer understands the risks associated with a particular strategy.

Inc. v. Northway, Inc., 426 U.S. 438 (1976); *In re: Westcap Enterprises*, 230 F.3d 717, 725 (5th Cir. 2000). As an objective standard, based on a hypothetical reasonable investor, the sophistication of an ordinary individual investor is irrelevant. The analysis requires, instead, examining the alleged oral representations, on the one side, and the risk disclosures that were made to the investor, on the other: Could a reasonable investor reviewing the risk disclosures rely on the alleged misrepresentations or omissions which the investor claims induced him or her to invest?

DOE claims that *Westcap* and *Banca Cremi*, cited by Appellants, are inapposite, as the plaintiffs in those cases were sophisticated. While those cases do discuss sophistication, the experience and sophistication of the investors in those cases only served to negate the materiality of the alleged misrepresentations and omissions that much more. Yet, in the *Brown* case, 400 ordinary plaintiff-investors sued based on alleged “oral statements presumptively made by Hutton as to the low risk, conservative character of the investment” *Brown*, 991 F.2d at 1031. Their sophistication was irrelevant. *Id.* at 1032 (“Although for present purposes we presume that the Limited Partners are unsophisticated investors and that the brokers initiated the transactions, the other relevant factors preclude a conclusion that the alleged reliance could have been justifiable”). Instead, the court held that the plaintiff-investors could not rely on these oral representations, because the offering documents contradicted the oral representations.

Indeed, the *Brown* court’s holding that “[a]n investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth” has been adopted and repeated by numerous courts. See *Ashland, Inc. v. Morgan Stanley & Co.*, 652 F.3d 333, 337-38 (2d Cir. 2011) (no cause of action where defendant provided “SEC-mandated statement” which “explicitly disclosed the very liquidity risks about which appellants

claim to have been misled”); *La. Pac. Corp. v. Money Mkt. 1 Institutional Inv. Dealer (In re: Merrill Lynch Auction Rate Secs. Litig.)*, 851 F. Supp. 2d 512 (S.D.N.Y. 2012) (same).

Rather than explain the *Brown* case, which clearly supports Appellants’ position, DOE has misstated a footnote in the decision as “specifically and preemptively rejecting the position that Respondents have taken here. . . .” DOE Brief at 22. This footnote relates to a separate legal proposition entirely: If the oral misrepresentations are not related to the risks disclosed in the offering materials, those misrepresentations may be material and justify reliance. In other words, an oral representation that “the investment is safe” cannot be material if the offering materials disclose that “the investment is not safe.” On the other hand, an oral representation that “the investment will double or triple shortly” can be material if the offering documents disclose “the investment is not safe.”

For example, DOE asserts the blanket claim that “[a] broker cannot evade this requirement [to have reasonable grounds for a recommendation] by separately disclosing some or even all of the risks of the investment to the customer.” DOE Brief at 16. In support of this statement, DOE relies on cases which are distinguishable on this point. In *Frankfort*, the respondent knew that the hedge fund he recommended (selling it away from his firm) had lost over 80 percent of its value in a few months and also knew this fact was not disclosed in the private placement memorandum. In that case, the delivery of the offering documents did not disclose the risk to investors.

Similarly, in *In re Foster*, which was an Offer of Settlement and provides no precedential value, the respondent “told a customer that the stock price of The Meadow Group would rise from \$.20 per share to at least \$.50 per share within six months, notwithstanding the fact that Meadow was a speculative investment.” *In re Foster*, 51 SEC 1211, 1213, 1994 SEC LEXIS

2107 (SEC July 20, 1994). The prospectus did not specifically discuss this risk, and the representation was, therefore, extrinsic to the prospectus.

2. **The risk disclosures, based on NASD Notice to Members 93-73, were not mere boilerplate.**

The central issue is, or should have been, whether the disclosures signed and initialed by the customers here adequately disclosed the information which DOE claims was misrepresented and/or omitted. To this, DOE avoids the question entirely by calling these disclosures “generic.” However, the disclosures Appellants provided to investors came directly from NASD Notice to Members 93-73. It is hard to imagine how Appellants should have divined what additional risks FINRA now insists needed to have been disclosed to the Brookstone customers if those risks were not even discussed in the central notice issued by FINRA’s predecessor.

Nevertheless, according to DOE, these “generic written disclosures” did not disclose interest rate risk or effective duration. This is false. Specifically, among the other items detailed in the risk disclosures (which were included as a table in their initial brief), Appellants disclosed that “[f]or Inverse Floating Rate CMOs, rising rates will lower interest payments and extend return of principal beyond the anticipated average life. This may increase or decrease your effective yield.” Appellants’ Brief at 3.

3. **DOE has failed to find a legal basis supporting a finding that Appellants engaged in intentional misconduct.**

DOE’s sole basis for justifying the finding of scienter is the fact that Appellants recommended inverse floating CMOs during a time when interest rates were persistently rising, in an unprecedented (and unforeseeable) manner, from July 2005 to July 2007. Otherwise,

DOE's argument fails to explain why the conduct was intentional or reckless as opposed to merely negligent and is, therefore, conclusory. *See* DOE Brief at 17-18.⁸

DOE has another problem with regard to scienter. For instance, DOE has asserted that "the hearing record shows [Appellants] did not" fully understand the risks associated with the CMOs their customers purchased. DOE Brief at 3. DOE also argues that the hearing record "contains no evidence that Turbeville and Kline gave any meaningful thought to effective duration . . ." and that, "[w]ithout this type of information, it was impossible for Turbeville and Kline to fully comprehend the degree of risk in their customers' accounts." *Id.* at 16. These statements do not support any finding of scienter.

Similar allegations were lodged in *Louisiana Pacific*, a collateralized debt obligation case. In that case, the plaintiff alleged that one defendant, Money Market One, "knew or reasonably should have known . . . the risks associated with auction rate securities generally and with the specific auction rate securities sold to [plaintiff] in particular," while simultaneously stating that "[i]n reality . . . Money Market One either did not read or did not understand the offering materials before recommending that [plaintiff] invest its working capital in suitable securities." *La. Pac.*, 851 F. Supp. 2d at 539-40. The court rejected these allegations of scienter as inadequate "for analyzing the knowledge and scienter requirements of a 10b-5 'unsuitability' claim . . . [b]ecause scienter requires more than 'merely a heightened form of negligence.'" *Id.* (citing *Novak v. Kasaks*, 216 F.3d 300, 312 (2d Cir. 2000)). Moreover, even if Appellants did not disclose effective duration, it is well established that "recklessness cannot be inferred from the failure to disclose." *Id.* at 539 (citing *Kalnit v. Eichler*, 264 F.3d 131, 143 (2d Cir. 2001)).

⁸ The genesis of DOE's conclusory argument could have arisen from the fact that the EHP's finding of scienter was also conclusory, as Appellants pointed out in their Brief.

III. CONCLUSION

Appellants were entitled to a fundamentally fair hearing to allow them the opportunity to obtain and present evidence undermining DOE's theory of the case, as well as an assurance that the evidence used would be based on competent witnesses with personal knowledge of the facts. That is not what Appellants received, and the DOE Brief makes it clear that DOE is uninterested in preserving the rights of respondents to a fundamentally fair hearing. The NAC has the ability – and the obligation – to review extended hearing panel decisions to ensure that DOE and the Office of Hearing Officers play by rules that will not call into question the fairness of the hearing process. Here, in the absence of the protections to which Appellants were entitled, the EHP turned this process into a Star Chamber exercise used to rubberstamp whatever conclusions DOE had made regarding Appellants. Consistent with the foregoing, as well as their Appeal Brief, Appellants respectfully request that the NAC reverse the EHP decision.

Dated: December 20, 2012

Respectfully submitted,

By: 

Alan M. Wolper, Esq.
Nathan W. Lamb, Esq.
Ulmer & Berne, LLP
500 W. Madison St., Ste. 3600
Chicago, Illinois 60661-4587
Email: awolper@ulmer.com
Email: nlamb@ulmer.com

James. D. Sallah, Esq.
Joshua A. Katz, Esq.
Sallah & Cox, LLC
2101 NW Corporate Blvd., Ste. 218
Boca Raton, Florida 33431
Email: jds@sallahcox.com
Email: jkatz@sallahcox.com

Attorneys for Appellants

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

Department of Enforcement,

Complainant,

v.

No. 20070011413501

Brookstone Securities (CRD No. 13366),
Antony Lee Turbeville (CRD No. 1721014),
Christopher Dean Kline (CRD No. 2597293) and
David William Locy (CRD No. 4682865)

Respondents.

CERTIFICATE OF SERVICE

I hereby certify, on this 20th day of December, 2012, I sent the foregoing **Reply in Support of Appeal** to be served as follows:

Original + 1 copy via regular mail and
via electronic mail:

Gary Dernelle, Esq.
Associate General Counsel
FINRA, Office of the General Counsel
1735 K Street, NW
Washington, DC 20006-1506
nac.casefilings@finra.org

1 copy via regular mail and
via electronic mail:

Karen E. Whitaker, Esq.
Senior Regional Counsel
FINRA
Department of Enforcement
12801 North Central Expressway, Suite 1050
Dallas, Texas 75243
karen.whitaker@finra.org

1 copy via regular mail and
via electronic mail:

David B. Klafter, Esq.
Regional Chief Counsel – Southern Region
FINRA
Crystal Corporate Center
2500 N. Military Trail, Suite 302
Boca Raton, FL 33431
David.Klafter@finra.org

1 copy via regular mail and
via electronic mail:

Adam Walker
FINRA
120 West 12th Street, Suite 800
Kansas City, MO 64105
Adam.Walker2@finra.org



Alan M. Wolper

SALLAH ASTARITA & COX, LLC
ATTORNEYS AT LAW

JOSHUA A. KATZ, ESQ.*

EMAIL: JAK@SALLAHLAW.COM

*ADMITTED TO PRACTICE
IN FLORIDA

ONE BOCA PLACE
2255 GLADES ROAD, SUITE 300E
BOCA RATON, FLORIDA 33431

TEL: (561) 989-9080
FAX: (561) 989-9020

WWW.SALLAHLAW.COM

New York Office
110 WALL STREET, 11TH FL
NEW YORK, NY 10005

New Jersey Office
60 POMPTON AVENUE
VERONA, NJ 07044

July 31, 2013

**VIA ELECTRONIC MAIL &
U.S. MAIL**

Karen E. Whitaker, Esq.
Senior Litigation Counsel
FINRA
12801 N. Central Expressway
Suite No. 1050
Dallas, Texas 75243

Re: *Antony Turbeville (CRD No. 1721014)/Investigation Matter 20130375047*

Dear Ms. Whitaker:

I would like to thank you for the professional courtesy of providing my client, Antony Turbeville ("Mr. Turbeville") with an additional week to submit this Wells Submission to the Staff in response to your letter to Joseph A. Parrish, Jr., Esq., dated Wednesday, July 3, 2013 (the "Wells Notice"), wherein you indicated that the Financial Industry Regulatory Authority ("FINRA") has made a preliminary determination to recommend that a disciplinary proceeding be brought against Mr. Turbeville. Mr. Turbeville respectfully submits that the Staff's recommendation to bring a charge of violating FINRA Rule 2010 in an Enforcement Proceeding against him is grossly misguided considering the law described herein, the timing of the preliminary determination, and the indisputable documentary evidence.

I. THE WELLS NOTICE

The Wells Notice asserts that Mr. Turbeville violated FINRA Rule 2010 by filing "a false Complaint against and attempt[ing] to intimidate customer witnesses in a FINRA disciplinary action." See Wells Notice at 1.

The timing of the Wells Notice is, at best, suspect. Significantly, Mr. Turbeville believes the Wells Notice was delivered within two days of service of the Complaint on two of the Defendants, as confirmed by the returns of service, and prior to service on the other three Defendants. Further, the Staff ignored FINRA's protocol, evidently in order to deliver the Wells Notice as quickly as it could. The Staff failed to contact Mr. Turbeville or his counsel, pursuant

to a Wells Call, to explain the substance of the proposed charges and delivered the Wells Notice without following the procedures required in FINRA Notice to Members 09-17 ("NTM 09-17").¹

Rather than Mr. Turbeville's appearing to be attempting to intimidate customer witnesses in an otherwise completed disciplinary proceeding, it is FINRA which is attempting to intimidate Mr. Turbeville into withdrawing a valid Complaint—and, by doing so, FINRA appears to be asserting itself as an advocate for customers in another forum, which raises serious questions as to the motives of FINRA staff.

II. OVERVIEW OF THE WELLS RESPONSE

As set forth herein, the Staff's interpretation of this conduct as a violation of FINRA Rule 2010 is grossly misplaced and constitutes an overreaching of authority and a vast wasting of valuable resources by the Staff on what should be simply a nonissue.

First, the Complaint is not "false," as the Staff claims. The allegations in the Complaint are demonstrably supported by account forms and disclosures signed by the defendants in the underlying action. In the absence of any details in the Wells Notice concerning the alleged falsity of the Complaint, this documentary support completely undermines any determination that the Complaint is "false."

Second, the Florida court, before which the Complaint is pending, is the proper authority for determining whether a complaint filed in a Florida court is "false." The Florida Rules of Civil Procedure, Florida statutes and the Rules Regulating the Florida Bar provide provisions for the determination of whether a complaint filed in court is "false," and it is against those standards by which the falsity of the Complaint must be judged. Ultimately, in accordance with those rules, the court is better positioned to make that determination, upon motion of a party.

Third, FINRA Rule 2010, while proscribing unethical conduct which might otherwise be technically legal, does not prohibit filing this Complaint with the Tenth Judicial Circuit in Polk County, Florida, under relevant authority.

Fourth, the Staff's issue with the Complaint is not in its alleged falsity (and there are no allegations disclosed through the Wells process by the Staff as to its falsity), but with the potential outcome of the filing of the Complaint—the alleged "intimidation" of customer witnesses. However, the Staff's interpretation of the filing of a complaint as an act of intimidation of witnesses falls well short of supplying allegations of intimidation, which requires

¹ Mr. Turbeville would also invite FINRA Senior Management to investigate the reason the Staff has violated NTM 09-17. The Department argued, and the Extended Hearing Panel found, that Mr. Turbeville's recommendations to customers were unsuitable based on his alleged failure to follow NASD Notice to Members 93-73. See *Dept. of Enforcement v. Brookstone Securities, Inc., et al.*, Extended Hearing Panel Decision at 51-52, Case No. 2007011413501 (May 31, 2012). Ironically, the Staff has assumed that it is not required to follow its own notices to members with regard to the Wells process. In order for FINRA to enforce its rules and regulations, it must also be bound by the same rules and regulations.

evidence of unlawful coercion or duress. Filing a complaint is does not rise to this level of illegality unless the court enters findings that its filing was, in fact, unlawful.

III. WELLS RESPONSE

A. THE COMPLAINT IS NOT FALSE

1. THE ALLEGATIONS ARE TRUE AND HAVE A GOOD-FAITH BASIS

There is nothing in the Complaint which is false, and the Staff has failed to specify any false allegations in the Complaint.² The Staff have merely asserted, by contrast, that it "will allege that Turbeville filed a false Complaint against . . . customer witnesses in a FINRA disciplinary action. . . ." Wells Notice at 1.

As the Staff is fully aware, the factual allegations in the Complaint arise mainly out of the documents which formed part of the record in the disciplinary case against Mr. Turbeville. Those documents, including the new account forms and CMO disclosures which were signed and/or initialed by the Defendants on numerous occasions, are specifically referenced in the Complaint and cannot be said to be "false." While the Staff may dispute whether Mr. Turbeville reasonably relied on those documents in recommending the securities purchased by the Defendants, such a dispute is a dispute of interpretation of fact and is not evidence of the falsity of the Complaint. Below, we have provided the Staff with a comparison of the allegations by Mr. Turbeville with the proof of those allegations to demonstrate that the Staff will have an exceedingly difficult time proving the falsity of the Complaint.

COMPLAINT

PROOF

10. In or around 2005, Mr. Turbeville set up investment accounts for Defendants Ms. B., Ms. C., Mr. R., and Mrs. R. (collectively the "Clients"). In their new account agreements (the "Agreements"), the

The new account forms ("NAFs") speak for themselves, but clearly and unequivocally reflect the relevant customer investment information. Copies of the NAFs are included in Exhibit A, attached hereto.

² Notice to Members ("NTM") 09-17 provides a number of safeguards with regard to disciplinary proceedings. Among other things, NTM 09-17 provides that the Staff would call the respondent or his, her or its counsel to discuss the substance of the evidence supporting the proposed charge(s). According to NTM 09-17, the Wells Call is followed up immediately with a Wells Notice to confirm the Wells Call. The undersigned is unaware of any such Wells Call. Further, the Staff knows that Mr. Turbeville is, and has been, represented by the undersigned's law firm and Alan Wolper, Esq., of Ulmer Berne, in connection with the appeal of the disciplinary proceeding. Nevertheless, the Staff failed to contact the lawyers representing Mr. Turbeville in the proceeding which allegedly provides support for the Wells Notice. Given the total failure to adhere to its own procedures for issuing the Wells Notice, Mr. Turbeville suspects that the Staff has initiated this Wells Notice without any adequate review by senior management in order to intimidate Mr. Turbeville.

Clients specifically indicated what type of investment style they wished to undertake, the number of years investing experience they had, and the importance of their investment objectives (numerically ranked).

This allegation is purely factual and indisputable.

11. Accompanying each of these Agreements, and signed by each of the Clients, was a customer risk assessment form ("Risk Form") which asked what level of risk the Clients were willing to take. The Risk Form described each risk level with different examples of the types of investments that would be used, as well as what the Clients should expect in taking on such a risk.

The Risk Forms speak for themselves. Copies of the Risk Forms are included in Composite Exhibit A. This allegation is purely factual and indisputable.

12. The Clients also filled out a disclosure (the "Disclosure") for collateralized mortgage obligations ("CMOs"), which explained that CMOs would be purchased as part of the Clients' investment portfolios and which types of CMOs would be invested in. The Disclosure also ensured that the Clients had read the Investor's Guide to Collateralized Mortgage Obligations, a document which explains CMOs to the Clients and the risks associated with this type of investment instrument.

The CMO Disclosures speak for themselves. Copies of the CMO Disclosures are included in Composite Exhibit A. This allegation is purely factual and indisputable. A review of the CMO Disclosures reveals that the Clients did, in fact, indicate that they had read the Investor's Guide to Collateralized Mortgage Obligations.

13. CMOs were included in the description for the level of risk that each of the Clients indicated they were willing to take and the Clients had actual knowledge of the fact that their investment portfolios were to be made up of CMOs.

It is indisputable that the Client-Defendants executed the forms included in Exhibit A. Based on their execution of these documents, this statement is not false.

14. At the time the Agreement, Disclosures, and Risk Forms were signed, each of the Clients represented that they had over ten years of investing experience and, as such, were well aware of the type of investors they were, what their investment objectives were, and their tolerance to risk corresponding to their investment objectives.

See Exhibit A. There is nothing false in this allegation.

15. Each of the Clients, by signing the Agreement, Disclosures and Risk Forms, indicated to Mr. Turbeville that their investment objectives were for aggressive income and that they were willing to purchase CMOs as the means for achieving this aggressive income.

See Exhibit A. There is nothing false in this allegation.

16. Each of the Clients signed his or her Agreement, Disclosures, and Risk Forms with the intent to induce Mr. Turbeville to provide financial planning and investment services in reliance on the information laid out in each of the signed documents, and to make the proper investments in order to match each of the Clients' investment style and risk tolerance.

This statement is not false. The Client-Defendants intentionally signed these documents in order to obtain financial services from Mr. Turbeville.

17. In reliance upon the Agreements, Disclosures, and Risk Forms signed by the Clients, Mr. Turbeville undertook an investment strategy for each of the clients using CMOs as the primary investment instruments for the Clients' investment portfolios.

As you are aware, FINRA Rule 2310 provides that a registered representative is permitted to rely on customer representations when undertaking to provide investment advice to customers. There is nothing false in this statement.

18. When the Clients investments later showed significant losses due to fluctuations in the interest rate, the Clients removed their investments from Brookstone (and Mr. Turbeville). Not long thereafter, the Financial Industry Regulatory Authority ("FINRA") commenced an investigation of Mr. Turbeville and Brookstone. During the process, FINRA attorneys and/or investigators solicited testimony from each of the Clients. No formal complaints were ever filed by the Clients themselves.

See Transcripts of Proceedings in *Dept. of Enforcement v. Brookstone Securities, Inc., et al.*, Disciplinary Proceeding No. 2007011413501, Extended Hearing Panel Decision (May 31, 2012). There is nothing false in this allegation, and the Staff cannot controvert its truth.

19. As a result of the Clients' statements, the Department of Enforcement for FINRA instituted proceedings against Mr. Turbeville and held a hearing at which time each of the Clients testified and presented evidence against Mr. Turbeville.

Id. There is nothing false in this allegation, and the Staff cannot controvert its truth.

20. Each of the Clients testified before the FINRA panel, contrary to their signed Agreement, Disclosures, and Risk Forms, that they did not understand how CMOs worked and that they had never understood how they worked.

Id. There is nothing false in this allegation, and the Staff cannot controvert its truth.

21. Each of the Clients further testified, contrary to their signed Agreement, Disclosures, and Risk Forms, that their investment objectives were not aggressive and that they only intended Mr. Turbeville to invest in low risk securities with the strategy of asset preservation rather than aggressive income.

Id. There is nothing false in this allegation, and the Staff cannot controvert its truth.

22. As a result of the negligent or fraudulent misrepresentations, Mr. Turbeville lost his business, suffered damages in excess of one million dollars (\$1,000,000), and was barred from associating with any FINRA-regulated firm in any capacity.

See Id. There is nothing false in this allegation, and the Staff cannot controvert its truth.

23. Mr. Turbeville relied upon the fraudulent and/or negligent misrepresentations contained in the Contracts, Disclosures, and Risk Forms in structuring the Clients' investment portfolios with CMOs. As a result of Mr. Turbeville's reliance on the Clients' fraudulent and/or negligent misrepresentations, Mr. Turbeville has suffered severe financial damages.

There is nothing demonstrably false in this statement.

The allegations, above, constitute the basis for all claims asserted by Mr. Turbeville against the Client-Defendants. As seen from the table, above, the inferences and claims based on these allegations are constructed from indisputable evidence, regardless of the Staff's opinion about the implications these allegations have for the liability of the Client-Defendants.

However, to the extent the Staff believes any of the foregoing allegations is false, the undersigned would invite the Staff to provide Mr. Turbeville with greater detail in order to formulate a response. As you are aware, the Staff never provided a detailed Wells Call to explain the Staff's position, in violation of NTM 09-17, and any complaint against Mr. Turbeville would necessarily require far more detailed explanations for the falsity of the allegations.

2. THE PRIOR DISCIPLINARY DECISION HAS NO PRECLUSIVE EFFECT IN FLORIDA COURTS

Despite the absence of any specificity in the Wells process, the undersigned suspects that the Staff believes that the prior disciplinary decision serves as a means to disprove the veracity of the allegations in the Complaint, notwithstanding the analysis above.³ However, the prior proceeding can supply no issue-preclusive effect in the Courts of the State of Florida.

As an initial matter, the findings in the disciplinary proceeding are not final. As you are aware, the Respondents in the disciplinary proceeding appealed the findings of the extended hearing panel to the National Adjudicatory Council ("NAC"), and that appeal (as well as any subsequent appeals from the NAC) has not yet been exhausted. As part of that appeal, Mr. Turbeville has argued that he did not receive a fair hearing, including, among other arguments, that these same Client-Defendants' testimony was either unreliable or that the Hearing Office prevented Mr. Turbeville from obtaining documents necessary to undermine the credibility of these witnesses' testimony. Based on the fact that the disciplinary case is still subject to the appeals process, FINRA cannot rely on the "truth" of the Extended Hearing Panel Decision to prove the falsity of Mr. Turbeville's Complaint.

However, even if the Extended Hearing Panel Decision could be considered to be final, there are no judicial theories on which the Department could rely to prove the falsity of the Complaint. For instance, Florida courts do not permit judicial estoppel unless (a) the parties are identical and (b) the parties presented an identical issue in a prior proceeding. *See Mobil Oil Corp. v. Shevin*, 345 So.2d 372, 374 (Fla. 1977). Similarly, *res judicata* requires, in addition to a final judgment in the prior suit, identity of parties and identical causes of action in both the prior and second suit. *See Jones v. SEC*, 115 F.3d 1173, 1178 (4th Cir. 1997); *see also Dept. of Enforcement v. John Leighton, et al.*, Decision at 11, Complaint No. CLG050021 (NAC, Mar. 3, 2010) (refusing to apply *res judicata* or collateral estoppel in NASD disciplinary proceeding against supervisors following a federal district court's final order dismissing claims against alleged primary violator and supervisors in action brought by the Securities and Exchange Commission ("SEC"), as the NASD was not a party to the SEC action). The Client-Defendants were not parties in the disciplinary proceeding, and the issues raised in the Complaint are distinct, even if they are related.

It is ironic that the Department itself provided proof of the falsity of the representations of the Client-Defendants as part of the disciplinary proceeding against Mr. Turbeville. The Staff purportedly proved that the investment recommendations for the Client-Defendants were

³ The Staff has a conundrum here. For instance, if the Staff believes the disciplinary proceeding is a final determination that would demonstrate the alleged falsity of Mr. Turbeville's Complaint, then the same finality of that proceeding would mean there could be no intimidation of the customer witnesses. Following this logic, the evidence is closed, and no amount of intimidation could alter the testimony in that case.

contrary to the investment objectives, risk tolerance and investment sophistication the Client-Defendants represented to Brookstone and Mr. Turbeville. Assuming the Client-Defendants testified truthfully, as the Staff must, it is clear that their representations when opening up their accounts were negligently or fraudulently false and misleading. Since the clients were under oath and FINRA allegedly substantiated the testimony through its investigation the only remaining conclusion is that the clients were either grossly negligent or fraudulent on their NAFs.

Regardless of what FINRA attempted to prove through the Extended Hearing Panel Decision, it is insufficient to prove the falsity of Mr. Turbeville's Complaint pending in the Tenth Judicial Circuit in Polk County, Florida.

B. THE COURT IS THE PROPER JURISDICTION TO DETERMINE THE FALSITY OR MERITORIOUSNESS OF THE COMPLAINT

Regardless of whether the Staff could provide any details showing the falsity of the Complaint, a FINRA disciplinary proceeding is hardly the forum for such an endeavor. Moreover, the possibility of parallel proceedings before FINRA and the Court could lead not only to inconsistent results, but frankly absurd results—with one forum finding a "false" Complaint and the other finding a meritorious one.

Complicating matters even further, while Florida courts have a well-developed means of analyzing whether a complaint is frivolous, through various statutes and rules, FINRA has none. Florida courts have explicit powers to determine the falsity of all pleadings and other filings before the Court. Rule 1.150, FLA. R. CIV. P., for instance, provides:

- (a) If a party deems any pleading or part thereof filed by another party to be a sham, that party may move to strike the pleading or part thereof before the cause is set for trial and the court shall hear the motion, taking evidence of the respective parties, and if the motion is sustained, the pleading to which the motion is directed shall be stricken. Default and summary judgment on the merits may be entered in the discretion of the court or the court may permit additional pleadings to be filed for good cause shown.
- (b) The motion to strike shall be verified and shall set forth fully the facts on which the movant relies and may be supported by affidavit. No traverse of the motion shall be required.

Additionally, Section 57.105, FLA. STAT., provides:

- (1) Upon the court's initiative or motion of any party, the court shall award a reasonable attorney's fee, including prejudgment interest, to be paid to the prevailing party in equal amounts by the losing party and the losing party's attorney on any claim or defense at any time during a civil proceeding or action in which the court finds

that the losing party or the losing party's attorney knew or should have known that a claim or defense when initially presented to the court or at any time before trial:

- (a) Was not supported by the material facts necessary to establish the claim or defense. . . .

Here, no party in the underlying action has deemed any pleading or any part thereof to be a sham, as no such motion has been filed with the Court, and the undersigned is unaware of the service of any motion by the Client-Defendants pursuant to Section 57.105(4), FLA. STAT.

Further, Mr. Turbeville's attorneys filed this Complaint in accordance with their obligations of their oaths to the Florida Bar. Rule 4-3.1 of the Rules Regulating the Florida Bar provides: "A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law." Thus, by signing the pleading, Mr. Turbeville's attorneys represented to the Court, as members of the Florida Bar and as subject to its disciplinary procedures, that they had conducted a good faith review of the facts in the action and determined that they are not frivolous.

These statutes and rules set forth specific standards for determining whether a complaint is frivolous and sanctionable by Florida courts—and, of course, cases have been litigated to test the limits of what is frivolous and what is meritorious. By contrast, FINRA has no express rules to determine whether a complaint filed in another forum (over which FINRA has no jurisdiction) is frivolous and has little experience in dealing with actions for filing false complaints. *See Dept. of Enforcement v. Shvarts*, Decision, National Adjudicatory Council, Case No. CAF980029 at 9 (June 2, 2000) (where respondent ignored court order for payment of attorney's fees pursuant to Section 57.105, FLA. STAT., NAC noted the absence of disciplinary cases, but nonetheless found violation of NASD Rule 2110 as analogous to a violation of a regulatory consent order).

**C. FINRA RULE 2010 DOES NOT PROSCRIBE THE ALLEGED CONDUCT, UNLESS
THE FLORIDA COURT DETERMINES THAT THE COMPLAINT IS FALSE**

The requirement under Florida law is simply that the Complaint not be frivolous—and FINRA cannot impose any greater requirement than what is required under Florida law for asserting the validity of the Complaint. Ultimately, whether the Complaint is "false" or meritorious must be measured against the standards under Florida law, because any attempt by FINRA to impose any greater standards would necessarily deprive members and associated persons of the right to file what would otherwise be meritorious complaints in court against former customers.

The assertion that FINRA Rule 2010 could encompass conduct beyond the scope of what is legally permitted under Florida law would run afoul of FINRA's goal of providing clear and understandable conduct rules for the guidance of its members. Robert Glauber, Chairman and Chief Executive Officer of NASD, stated in 2005 that "[w]rit[ing] clear and appropriate rules and enforcing them without fear or favor is . . . the heart and soul" of FINRA's mission.

(Glauber, Address to Securities Industry Association Annual Meeting, Nov. 2005, Boca Raton, Florida, at http://www.nasd.com/web/ideplg/IdServices-SS_GET_PAGE&ssDocName=NASDW_05519). "[W]ithout fear or favor" is an important concept. Members should not fear that FINRA will bring an action against them when such member could not reasonably anticipate the factual circumstances upon which FINRA will allege violation of its Rules, including the Conduct Rule. Here, the use of FINRA Rule 2010 to prohibit conduct which is otherwise permitted under Florida law would be an abuse of FINRA's mission.

1. THE SCOPE OF FINRA RULE 2010

The Conduct Rule states simply: "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." In general, there is a two prong test that has developed for analyzing violations of the Conduct Rule: "(1) the misconduct occurred 'in the conduct of' the respondent's business; and 2) the misconduct contravened high standards of commercial honor or violated just and equitable principles of trade." *Dept. of Enforcement v. Foran*, Decision at 6, Case No. C8A990017 (Sept. 1, 2000).

The scope of the Conduct Rule is, by design, extremely broad. *See Shvarts, supra* at 7 ("The special focus of the NASD's Rules is the professionalization of the securities industry, and the rules are affirmatively and vaguely phrased in terms of what shall be instead of in terms of concrete proscriptions"). It is also concededly true that the Conduct Rule "is not limited to rules of legal conduct but rather that it states a broad ethical principle" *In re: Timothy L. Burkes*, 51 SEC 356, 360, 1993 SEC Lexis 949, *10 n.21 (April 14, 1993). The rule was "[p]romulgated to discipline 'a wide variety of conduct that may operate as an injustice to investors or other participants in the market place'" *Heath v. SEC*, 586 F.3d 122, 130 (2d Cir. 2009).

Ultimately, under Florida law, the Complaint need only have a basis in law and fact to avoid a finding that the Complaint is frivolous, in accordance with Rule 1.150, FLA. R. CIV. P.; Section 57.105, FLA. STAT.; and Rule 4.3-1 of the Rules Regulating the Florida Bar. If Mr. Turbeville's Complaint has satisfied this statute and these rules, then there could be no violation of FINRA Rule 2010: In order for FINRA to prove a violation of Rule 2010, FINRA must prove that Mr. Turbeville acted in bad faith and unethically as to the truth or falsity of the factual allegations in the Complaint. *See, e.g., Heath v. SEC*, 586 F.3d 122, 130 (2d Cir. 2009) (citing *Robert Kauffman*, 51 SEC 838 (Nov. 18, 1993), *aff'd*, *Kauffman v. SEC*, 40 F.3d 1240 (3d Cir. 1994)). The lack of proof of any underlying violation with the Florida court would mean that FINRA would have no basis for asserting that the Complaint is frivolous.

2. THE ONLY REMOTELY ANALOGOUS CASE FOUND A VIOLATION OF THE CONDUCT RULE BASED ON FAILURE TO PAY ATTORNEY FEES AND COSTS FOLLOWING A FINDING BY A FLORIDA COURT OF A FRIVOLOUS COMPLAINT—NOT PRIOR TO THE COURT'S FINDING

Here, however, based on the fact that the Complaint is meritorious, Mr. Turbeville cannot be said to have violated FINRA Rule 2010. No party has moved the Court to strike the Complaint pursuant to Rule 1.150, FLA. R. CIV. P. The Court has not determined that the

Complaint before it is frivolous within the requirements under Florida law. Yet, despite these rules and regulations against the filing of sham pleadings and frivolous lawsuits, the Staff has concluded that the Complaint is false.

In essence, the Staff is jumping the gun in alleging a violation of FINRA Rule 2010. For instance, in *Shvarts, supra.*, the only case which is remotely analogous to the proposed charges here,⁴ the respondent filed a complaint in Florida court to determine that he was not properly served with the claimants' statement of claim, as he was allegedly in hospital, following an adverse arbitration award. The Florida court rejected this allegation and awarded attorney's fees and costs against the respondent pursuant to Section 57.105, FLA. STAT., which includes, as noted above, "a complete absence of a justiciable issue of either law or fact raised by the complaint. . . ." *Id.* at 11 n.17.

The Department of Enforcement commenced a disciplinary proceeding against the respondent for violating NASD Rule 2110—but *not until after the Florida court's decision awarding fees and costs pursuant to Section 57.105*—for violating a court order and for unethical behavior. However, the fact that Shvarts had submitted a meritless complaint did not factor directly in the NAC's decision finding a violation of Rule 2110.

For instance, the NAC stated: "We are holding that Shvarts' failure to comply with the court order violated Conduct Rule 2110, *not that his filing a lawsuit violated the rule.*" *Id.* at 11. The determination of the merits of Shvarts' complaint was unnecessary for the NAC, because that determination was already made by the court. But by filing a complaint in Florida court, "Shvarts should have played by the rules of the game in which he forced the [claimants] to join. Because the court determined that he owed the attorneys fees and costs to the [claimants], he should have paid. His failure to pay was 'dishonorable and inequitable conduct.'" *Id.* at 10 (citation omitted). *It was this conduct, and not the filing of a frivolous complaint, which constituted the "injustice to investors."* *Id.* (citation omitted).

Shvarts had argued before the Hearing Panel and the NAC that his conduct in Florida court was immune from discipline under Conduct Rule 2110 and that he was merely pursuing his legal rights—an argument which was rejected by the NAC. Mr. Turbeville is not making the same argument here. Instead, Mr. Turbeville is arguing that the Florida court has not determined—or even had the opportunity to determine—whether his Complaint is frivolous.

If the Florida court were to make that determination, following Mr. Turbeville's opportunity to correct any such mistakes before the Florida court, then Mr. Turbeville would certainly understand the basis for a charge of violating FINRA Rule 2010 and could defend himself against such a charge based on the outcome of the court proceeding. If, for instance, Shvarts had complied with the Florida court's order to pay attorneys fees and costs, there might have yet been a valid claim for violating NASD Rule 2110. But it is clear, based on the Shvarts

⁴ To the extent the Staff believes there are other cases which would be analogous to the allegations and charge in the Wells Notice, Mr. Turbeville requests that the Staff supply him with copies of those decisions and provide him with an opportunity to address those decisions in a supplemental Wells Response, if permitted.

decision, the NAC did not reach that conclusion and decided, instead, that the violation was the failure to pay pursuant to a finding that the respondent was liable pursuant to Section 57.105.

Under the current procedural posture of the Florida action, however, any attempt by FINRA to determine that his Complaint is false would be premature and would constitute impermissible and unethical interference with Mr. Turbeville's right to seek legal redress in court.

D. THE CLAIMS OF INTIMIDATION ARE UNSUPPORTED BY ANY PREDICATE

The second part of the Wells Notice claims that Mr. Turbeville has attempted to intimidate customer witnesses. This claim is factually and legally incorrect.

First, as indicated above, the customer witnesses have already given testimony before the Extended Hearing Panel. Even assuming that Mr. Turbeville were able to provide some pressure—even legal pressure—on these witnesses, their testimony has been recorded, under oath, and is unchangeable. And even if these witnesses somehow changed their testimony before the Extended Hearing Panel (and, ironically, in accordance with their signed new account forms, disclosures and, in the case of the Raus, prior affidavits), the effect on the disciplinary proceeding would, certainly, be negligible if at all, as the appellate argument before the NAC is already concluded.

Second, the Staff's claim of witness intimidation is focused on the result of filing a complaint, rather than any alleged conduct which would give rise to any finding of intimidation. Black's Law Dictionary defines intimidation as "unlawful coercion; extortion; duress; putting in fear." The requirement is not merely that there is any pressure exerted against a witness from filing an otherwise meritorious complaint, but that the pressure is accomplished through illegal means. The filing of a complaint might inconvenience a defendant, but it does not, in itself, mean that the plaintiff has exerted any such "unlawful coercion" against the defendant-as-witness in another proceeding.

The only possibility for claiming witness intimidation, under this, or any definition, would require allegations that the Complaint is, in fact, *knowingly* false and filed for the purpose of exerting such illegal pressure to convince a witness to testify untruthfully. As indicated above, the Staff has not provided any information from which Mr. Turbeville could be apprised as to the alleged falsity of his complaint.

Third, as long as Mr. Turbeville has a reasonable basis for his Complaint, the Complaint is a legitimate filing with the Florida court and cannot serve as a basis for the Staff's allegations that he attempted to intimidate customer witnesses. In essence, the meritoriousness of the Complaint would overcome any claim that he could have attempted to intimidate witnesses.

IV. Conclusion

Mr. Turbeville submits that filing a disciplinary action against him based on filing of the Complaint, without any indication as to the falsity of the factual allegations in the Complaint, would be antithetical to the principals and goals of FINRA as articulated by Mr. Glauber. The case law overwhelmingly indicates that an enforcement action based on a violation of FINRA Rule 2010 must be based on some conduct involving fraud, deceit, conversion, misappropriation of information or a breach of trust and confidence. And while the Staff has concluded that the Complaint is "false," there is no indication as to how the Staff reached that conclusion. Moreover, as indicated, above, the factual allegations are actually truthful and based on documentary evidence.

Accordingly, we respectfully request that the Staff reconsider its preliminary determination to recommend a charge be brought in this case and instead close this matter without further action. At the very least, FINRA should consider abstaining from any such action pending a determination by the Florida court.

Very truly yours,

Joshua A. Katz

Encl:

Cc: Client
Joseph A. Parrish, Jr., Esq.