

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 59328 / January 30, 2009

Admin. Proc. File No. 3-12933

In the Matter of the Application of

SCOTT EPSTEIN

c/o George L. Mahr, II
Mahr and Mahr, LLC
80 Main Street
P.O. Box 534
Madison, NJ 07940

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY
PROCEEDING

Unsuitable Recommendations

Former registered representative of member firm of registered securities association made unsuitable recommendations to customers. Held, association's findings of violation and the sanction it imposed are sustained.

APPEARANCES:

George L. Mahr II and George L. Mahr III, of Mahr and Mahr, LLC, for Scott Epstein.

Marc Menchel, Alan Lawhead, and Gary J. Dernelle, for FINRA.

Appeal filed: January 17, 2008
 Last brief received: July 7, 2008 1/

I.

Scott Epstein, a former registered representative with Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch" or the "Firm"), a member of the Financial Industry Regulatory Authority, Inc. ("FINRA"), appeals from FINRA disciplinary action. 2/ FINRA found that Epstein made unsuitable mutual fund switch 3/ recommendations to customers in violation of NASD Rules 2310, 2110, and IM-2310-2. 4/ For these violations, FINRA barred Epstein from

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- 1/ On July 15, 2008, FINRA moved for leave to file a sur-reply to Epstein's reply brief. Commission Rule of Practice 450 states that "No briefs in addition to those specified in the briefing schedule order may be filed except with leave of the Commission." 17 C.F.R. § 201.450. The briefing schedule order does not contemplate the filing of a sur-reply and we have determined that the filing of FINRA's additional brief is unnecessary to our review of Epstein's appeal. Accordingly, we deny FINRA's motion.
- 2/ On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. Because the final disciplinary action on appeal here was taken after the consolidation, references to FINRA herein shall include references to NASD.
- 3/ A mutual fund switch involves one or more mutual fund redemption transactions coupled with one or more related mutual fund purchase transactions. See Laurie Jones Canady, 34 S.E.C. 65, 68 n.5 (1999) (citing Russell L. Irish, 42 S.E.C. 735, 737 n.5 (1965) (defining mutual fund switch), aff'd, 367 F.2d 637 (9th Cir. 1966)), petition denied, 230 F.3d 362 (D.C. Cir. 2000).
- 4/ NASD Rule 2310, sometimes referred to as the "suitability rule," requires that, in recommending the purchase, sale, or exchange of any security to a customer, a member must have reasonable grounds for believing that the recommendation is suitable for that customer based on the facts, if any, disclosed by the customer as to his other securities holdings and the customer's financial situation and needs. NASD Rule IM-2310-2 imposes on members and registered representatives the obligation of "fair dealing" in relationships with customers, and states that sales efforts must be undertaken within NASD's ethical standards. NASD Rule 2110 requires the observance of "high standards of commercial honor and just and equitable principles of trade." A violation of the

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acting in any capacity with any member firm. ^{5/} We base our findings on an independent review of the record.

II.

A. Background

Epstein joined Merrill Lynch in August 2000 after graduating from college and was assigned to a Merrill Lynch “call center” in Hopewell, New Jersey, the Financial Advisory Center (the “FAC”). ^{6/} Epstein was a registered general securities representative whose official title was Investment Services Advisor (“ISA”).

The FAC handled Merrill Lynch accounts with assets of \$100,000 or less. Merrill Lynch transferred such accounts from its branch offices to the FAC. Whenever a customer called Merrill Lynch, the call would be routed to a randomly-selected and available ISA. ISAs also would make unsolicited telephone calls to customers whose accounts had been transferred to the FAC. Customer conversations routinely were recorded by the FAC.

ISAs were permitted to make securities recommendations regarding mutual funds but not individual stocks and bonds except when a customer requested such advice. In his investigative testimony to NASD, Epstein stated that, when speaking with a customer, whether on an inbound call or on an unsolicited basis, the ISAs had access to information via their desktop computers and other proprietary databases regarding when a customer had opened an account, the customer’s age, marital status, income, total net assets, and the type of investments they held. However, Epstein’s counsel stated in an affidavit filed with the Commission in this proceeding that the ISAs frequently experienced difficulties with “the FAC computer system,” which “crashed constantly.”

^{4/} (...continued)

NASD suitability rule is also a violation of NASD Rule 2110. See, e.g., Wendell D. Belden, 56 S.E.C. 496 (2003).

^{5/} FINRA also assessed costs. It declined to reach findings by its Hearing Panel that Epstein’s recommendations also were accompanied by misrepresentations and omissions of material fact. These allegations, therefore, are not before us.

^{6/} On March 15, 2006, Merrill Lynch settled NASD allegations relating to sales practice abuses at the FAC, without admitting or denying those allegations, by agreeing to a censure and a \$5 million fine, in addition to several undertakings. See NASD Fines Merrill Lynch \$5 Million for Call Center Supervisory Failures, Sales Contest Violations, <http://www.finra.org/Industry/Issues/Advertising/NewsReleases/2006/p115786> (last visited Dec. 3, 2008).

ISAs were divided into teams and were required to achieve certain levels of production. The FAC occasionally held sales contests with prizes for individual ISAs and teams based on their overall production. Although the ISAs were salaried employees, the Firm offered them substantial bonuses for increased production, which included mutual fund sales. For example, Epstein was paid a base salary of \$35,000 plus variable compensation consisting, in part, of bonuses called “production credits” for certain transactions. ^{7/} Epstein’s variable compensation for the period from October 1, 2001 through March 2, 2002, approximately the period at issue, totaled \$26,443.

Epstein, as a Merrill Lynch employee, agreed to comply with Merrill Lynch’s Compliance Outline Handbook (the “Handbook”). The Handbook required the representative to “discuss the investment objective, investment strategy and risks associated with investment in any recommended mutual fund” and “the advantages and disadvantages of the various available share classes,” including “front-end [and] back-end” loads, the Contingent Deferred Sales Charge (“CDSC”) peculiar to Class B and Class C shares, “the existence and effect of any on-going distribution and maintenance fees,” and the “availability of no-cost or low cost shares.” ^{8/} The

^{7/} The variable compensation consisted of three components: production; client contact/new money; and “focus scores” based on communication and customer service skills. Epstein was paid a percentage of the production credit amounts that he earned, depending on the nature of the transactions that he effected. As part of his variable compensation, Epstein also earned specific dollar amounts for achieving certain production credit “hurdles.”

^{8/} Generally, each mutual fund comprises several classes of shares that have different kinds of sales charges and operating expenses associated with them. See Rule 18f-3 under the Investment Company Act of 1940, 17 C.F.R. § 270.18f-3; Exemption for Open-End Management Investment Companies issuing Multiple Classes of Shares, 60 Fed. Reg. 11875, 11876 (Mar. 2, 1995). For example, the major cost associated with purchasing Class A shares is a sales charge known as a “front-end load.” See, e.g., Raghavan Sathianathan, Securities Exchange Act Rel. No. 54722 (Nov. 8, 2006), 89 SEC Docket 774, 775 (barring respondent for making unsuitable mutual fund recommendations and for unauthorized trading), petition denied, No. 07-1002, slip op. (D.C. Cir. Dec. 2, 2008); Mutual Fund Regulation § 18:4.1 (Clifford E. Kirsch ed., 2d ed. 2005). This sales charge is paid when the shares are bought and it is deducted from the amount invested (effectively reducing the quantity of mutual fund shares purchased). By contrast, Class B shares have a back-end sales charge – the CDSC – but no front-end load. Sathianathan, 89 SEC Docket at 776; see generally Investment Company Act Rule 6c-10, 17 C.F.R. § 270.6c-10; Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, 60 Fed. Reg. 11887 (Mar. 2, 1995). The CDSC is collected from the investor when the mutual fund shares are sold rather than at the time of purchase. Sathianathan, 89 SEC Docket at 776. Typically, the CDSC is reduced for

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Handbook cautioned that a switch should not be recommended “unless it will result in a net investment advantage for the client, considering all financial and other factors, including sales charges and tax consequences.”

Merrill Lynch also provided ISAs with a summary sheet or “script” describing mutual fund share classes and the fees and expenses associated with each, that were to be discussed with customers. The script contained additional information regarding which share class would make the “most sense” for different types of customers, depending on their investment time horizon, the amount they wished to invest, and their sensitivity to fees and expenses. ISAs were expected to inform customers that “[t]he share class that is right for you depends in large part on the period of time you intend to hold the shares and the amount of money you intend to invest.”

B. Epstein’s Mutual Fund Switch Recommendations

FINRA’s findings of violation relate to Epstein’s recommendations between October 2001 and February 2002 of various transactions for the accounts of twelve FAC customers, many of whom were elderly, retired, and/or unsophisticated. Several of them had limited understanding of the applicable fee structures and other attributes of the funds referenced in Epstein’s recommendations. Except as discussed below, Epstein did not inquire about the customer’s financial situation or investment objectives. Sidney D. Krasner, of S.D. Krasner and Associates, who was qualified as an expert for NASD by the Hearing Panel, testified that Epstein “failed to secure sufficient information from these clients in order to make the kind of recommendations he made.” According to Krasner, Epstein had an obligation “to refresh the record as to the risk tolerances and the investment objectives of these people,” and “in most cases, [Epstein] failed to do that.”

1. Thomas Reed

In October 2001, Epstein made an unsolicited telephone call to the seventy-eight year old Reed to discuss his IRA account, which consisted primarily of mutual funds. During their four-and-a-half minute conversation, Epstein recommended that Reed switch mutual funds into

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each year that an investor holds Class B shares, phasing out entirely after a certain number of years. *Id.* Class C shares also impose a CDSC, *see* Mutual Fund Regulation at § 18:4.1, but that charge is usually eliminated after those shares have been held for more than one year.

something “a little bit more stable for you” Epstein informed Reed that “it’s not going to cost you . . . at all . . . to make the change.” Reed acceded to the switch. 9/

On October 15, 2001, Epstein executed the following transactions in Reed’s IRA account:

Sold \$89,524 Merrill Lynch High Income Bond Fund Class B shares.

Bought \$88,000 Alliance US Government Bond Fund Class B shares.

This switch resulted in a production credit to Epstein of \$3,520.

Reed had owned the Merrill Lynch High Income Bond Fund Class B shares since 1993. They had an expense ratio of 1.29%, while the Alliance US Government Bond Fund Class B shares had an expense ratio of 2.80%.

Because the IRA had held the Merrill Lynch High Income Bond Fund Class B shares for more than four years, and the holding period for the back-end sales charge – the CDSC – for that investment had expired, Reed incurred no CDSC upon the sale of those shares. However, Epstein did not inform Reed that the Merrill Lynch High Income Bond Fund Class B shares would convert automatically into less expensive Class D shares of that fund with an expense ratio of 0.77% within two years (*i.e.*, ten years after the original date of purchase). 10/ By switching the Merrill Lynch Class B shares out of that mutual fund less than two years before they were due to convert into less costly Class D shares, Epstein interrupted the holding period and eliminated the availability of a lower expense ratio for Reed’s investment. Epstein also did not inform Reed that switching to the Alliance US Government Bond Fund Class B shares would trigger a new three-year CDSC holding period and higher operating expenses than the Merrill

9/ Reed’s side of the recorded conversation can be heard clearly, while portions of Epstein’s remarks are inaudible. Nonetheless, it is clear from both the transcript and the recording of the conversation that Epstein recommended that Reed switch mutual funds.

10/ The expense ratio for Class B (or Class C) shares typically is larger than for Class A shares. See generally Mutual Fund Regulation at § 18:4.1. According to NASD expert witness Krasner, Class B shares typically convert to either Class A shares with lower operating costs or to another share class with lower operating costs, usually after six to ten years. See also Investment Company Act Rule 18f-3(f), 17 C.F.R. § 270.18f-3(f); Exemption for Open-End Management Investment Companies issuing Multiple Classes of Shares, 60 Fed. Reg. at 11878. For example, according to Krasner, many Merrill Lynch Class B shares convert to Class D shares that have lower operating expenses than Class B shares but higher operating expenses than Class A shares. In other fund families, Class B shares eventually convert to Class A shares. See Sathianathan, 89 SEC Docket at 776.

Lynch High Income Bond Fund Class B shares. ^{11/} Epstein further did not tell Reed he could switch from the Merrill Lynch High Income Bond Fund Class B shares to the Merrill Lynch U.S. Government Fund Class B shares, with an expense ratio of 1.52%, without triggering a new CDSC holding period. Moreover, the Merrill Lynch U.S. Government Fund Class B shares would have matured into Class D shares, with an expense ratio of 1.00%, in less than two years because the investment would have maintained its original 1993 Merrill Lynch purchase date.

NASD expert Krasner observed that “[n]one of the inherent costs (or lost benefits) were discussed with Mr. Reed.” Krasner testified that, although this switch was out of a “junk-bond fund” into a “more conservative” investment, Epstein failed to alert Reed that “the alternative for this switch was to buy the Merrill Lynch United States Government fund” which “would have been cost free, because the switch would have been within the same family of funds.”

An NASD compliance specialist testified at the hearing that Epstein would not have received any production credit for recommending an exchange within the same mutual fund family. She also testified that, based on her review of Epstein’s conversations with the customers, there were “no instances” where Epstein offered or discussed with customers the possibility of a free exchange of a mutual fund they already owned to another fund within the same fund family.

2. Doris Baumann

In October 2001, Epstein made an unsolicited telephone call to the residence of Doris Baumann, then an eighty-one year old homemaker, to discuss her Merrill Lynch trust account, of which she was the trustee. Baumann held a combination of mutual funds and individual stocks in that account. Epstein did not reach Baumann, but instead spoke to an individual who identified himself as Baumann’s husband (“R. Baumann”).

During their seven-and-a-half minute conversation, Epstein recommended to R. Baumann that Baumann switch from the Putnam New York Tax Exempt Fund, whose yield had fallen, to an Alliance fund that, Epstein stated, would provide Baumann with a better tax-free yield. Epstein assured R. Baumann that the switch to the Alliance fund “wouldn’t incur any sort of

^{11/} Generally, according to Krasner, investors who switch funds within the same fund family can “tack” their holding period from the old fund to the new fund within that fund family. For example, if an investor who holds a class of shares with a CDSC that phases out after five years switched to another fund within the same fund family after two years, those two years would be credited toward the total five year period to which the CDSC would apply. Thus, the investor’s original purchase date would be deemed the starting point for the calculation of any CDSC holding period for any fund within the same fund family. By contrast, according to Krasner, there usually is no tacking for switches between funds in different fund families. Switching between funds from different fund families would restart the holding period.

upfront sales charge” and that “there would just be a one-year hold on the investment.” Epstein also informed him that “if you sold it in the first year, there’d be a 1 percent charge,” but if “you hold onto it longer than that, no charge at all.” At one point during the conversation, R. Baumann seemed confused, stating “[L]et me make – make sure. Let me – let me clear that up in my own mind.” Eventually, R. Baumann acceded to Epstein’s recommendation.

On October 18, 2001, Epstein executed the following transactions in Baumann’s trust account:

Sold \$93,892 Putnam New York Tax Exempt Income Class A shares.
Bought \$93,000 Alliance Municipal Income Fund NY Class C shares.

This switch resulted in a production credit to Epstein of \$3,720.

The Putnam New York Tax Exempt Income Class A shares had an expense ratio of 0.82%, while the Alliance Municipal Income Fund NY Class C shares had an expense ratio of 1.47%. R. Baumann stated in his declaration to NASD that he “did not understand the difference in expenses between the different classes of shares and Scott Epstein never explained it to [him].” ^{12/}

In analyzing these transactions, Krasner questioned the suitability of Epstein’s recommendation. Krasner noted that, although the performance of the two funds was “almost identical” over a five year period, the “total return for year 2000 was more than 200 basis points better for the Putnam Fund than for the Alliance Fund.” According to Krasner, Epstein recommended a switch “from a Class A mutual fund, which already had reduced operating costs, into a Class C mutual fund that had substantially higher operating costs,” and “those operating costs were never going to go away.” Krasner also noted that “Epstein never explained . . . that there would be ongoing and continuing operating costs.”

Epstein did not inquire as to Baumann’s financial or tax status or other circumstances. As a result of the switch, Baumann realized a capital gain of \$8,000 and incurred a corresponding tax liability of approximately \$1,200. In his declaration to NASD, R. Baumann stated that “[a]t

^{12/} Class B and Class C shares typically carry higher distribution-and-service fees (“12b-1 fees”) than Class A shares. See generally Mutual Fund Regulation at § 18:4.1. Accordingly, the total annual fund operating expense ratios for Class B and Class C shares generally are higher than those for Class A shares. See, e.g., Sathianathan, 89 SEC Docket at 776. The 12b-1 fees on Class B and Class C shares function as an ongoing sales charge for those shares and are deducted from the fund’s assets. Class B shares typically convert to Class A shares (or to another class with lower 12b-1 fees) some time after the Class B shares’ CDSC holding period has phased out. However, according to Krasner, Class C shares typically do not convert to another class of shares and thus continue to shoulder higher 12b-1 fees.

the time that [he] agreed to sell the Putnam, [he] never considered the tax consequences that [he] would be hit with." According to R. Baumann, "Epstein never discussed this with [him]" and if he had known, he would not have agreed to the switch.

3. Rose Roberts

In October 2001, Roberts, then a seventy-five year old widow, telephoned the FAC to inquire about the available balance in her money market account and to withdraw \$300 from that account. As Roberts later stated in her declaration to NASD, she "had no intentions at the time to buy or sell anything."

Roberts's call was routed to Epstein. During the approximately twenty minute conversation, Epstein, after determining that Roberts was "looking to generate mainly income," and despite her apparent reluctance, recommended that Roberts liquidate her existing Eaton Vance Virginia Municipal fund and switch to another mutual fund that would provide her with a "higher tax free yield." Epstein also recommended "moving the money" from her IRA money market account "into some government bonds in something that is going to provide you with a higher yield." Although Roberts told Epstein "You're going too fast for me" and "I think I'm lost here (laughing)," she eventually acceded to Epstein's recommendations. Epstein never mentioned the name of the fund into which he planned to switch Roberts and did not discuss fees and expenses.

On October 31, 2001, Epstein executed the following transactions in Roberts's trust account:

- Sold \$21,615 Eaton Vance Virginia Municipal Fund Class B shares.
- Bought \$21,000 Alliance Muni Income Fund II, Virginia Portfolio, Class B shares.
- Redeemed \$9,385 from the money market account.
- Bought \$10,000 Merrill Lynch Municipal Bond National Fund Class B shares.

Epstein received production credits of \$840 and \$400, respectively, for these transactions.

The Eaton Vance Virginia shares had a slightly higher expense ratio than the Alliance Muni Income Fund shares. However, Roberts was beyond the CDSC holding period in her Eaton Vance fund. Had Roberts remained invested in the Eaton Vance Virginia Municipal Fund Class B shares, they would have matured into Class A shares with an expense ratio of 0.87%. ^{13/} Instead, when Epstein switched Roberts from that fund into Alliance Class B shares, which was in a different fund family, it triggered a new six-year CDSC holding period with a higher expense

^{13/} The record does not indicate when the Eaton Vance Virginia Municipal Fund Class B shares would mature into Class A shares.

ratio than Roberts would have incurred had she maintained her Eaton Vance investment and the Class B shares matured into Class A shares. ^{14/}

Epstein also executed the following transactions in Roberts's IRA account:

Redeemed \$12,000 from the money market account within the IRA.
Bought \$12,000 Merrill Lynch Core Bond Fund Class B shares.

Epstein received a production credit of \$480 for this transaction.

Krasner noted that Epstein recommended that Roberts redeem some of her money market funds to buy government bonds. However, Epstein bought Merrill Lynch Core Bond Fund Class B shares instead. Krasner stated that Epstein never discussed the costs associated with that purchase nor provided Roberts with relevant information regarding the mutual fund. When Roberts received confirmation of these transactions, she became upset and, as she stated in a complaint letter to Merrill Lynch, contacted the FAC "many times during November-December 2001" attempting to reach Epstein, who "never returned any of [her] calls."

4. Vernan Brisson

In October 2001, Epstein made an unsolicited telephone call to the Brisson residence to discuss a joint Merrill Lynch account held by Vernan Brisson, his wife, and a third individual who was in her nineties. During their ten minute conversation, Epstein, without gathering any information from Vernan Brisson, almost immediately prodded Brisson into considering a mutual fund switch, stating that he would like to see some of Brisson's holdings "reinvested elsewhere" for "stability" of principal. Among other things, Epstein recommended switching to a "PIMCO bond fund," which he acknowledged was in "a different fund family," but emphasized its stability. Epstein recommended taking half of each of Brisson's mutual funds – a Franklin, a Lord Abbett, and two Merrill Lynch funds – and allocating them to "government issue bonds." Epstein stated that "there wouldn't be any sort of a front-end sales charge" for switching into the PIMCO Real Return Bond fund. Without discussing the different share classes, Epstein stated that "you pay the upfront sales charge to . . . get the best return" and that the "other two options" involved one-year and six-year holding periods, respectively. Brisson subsequently agreed to Epstein's recommendations.

^{14/} Class B shareholders pay their sales charge by either redeeming their shares during the CDSC holding period, thus incurring the back-end load, or by paying 12b-1 fees for the duration of the CDSC holding period until the Class B shares mature into Class A (or Class D) shares with a lower expense ratio. See Sathianathan, 89 SEC Docket at 776. According to Krasner, a long-term Class B shareholder who switches to Class B shares of another fund in a different fund family does not receive the benefit of tacking and must restart the entire process of paying the CDSC over a new holding period.