BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Bernard G. McGee Cazenovia, NY, Respondent.	DECISION Complaint No. 2012034389202 Dated: July 18, 2016

In connection with a customer's surrender of four variable annuities and purchase of a charitable gift annuity, respondent willfully omitted a material fact, made an unsuitable recommendation, engaged in undisclosed outside business activities, failed to timely update his Form U4, and made misrepresentations on his firm's annual compliance questionnaires.
Held, findings affirmed, sanctions affirmed in relevant part.

Appearances

For the Complainant: Edwin Aradi, Esq., Daniel Gardner, Esq., Leo Orenstein, Esq., Lane Thurgood, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Stephen Davoli, Esq., Kevin Van Duser, Esq.

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Decision

In March 2011, Bernard McGee's 71-year-old customer, CF, surrendered four variable annuity policies and used the proceeds to purchase a charitable gift annuity through 54Freedom Services, Inc. ("54Freedom"), a company that purported to sell insurance. In reality, the company was a fraudulent enterprise. This appeal focuses on McGee's role in CF's surrender of the variable annuities and purchase of the charitable gift annuity.

In the proceedings below, the Hearing Panel determined that McGee advised CF to liquidate a substantial portion of her portfolio, surrender the variable annuities, and invest the proceeds in 54Freedom's charitable gift annuity, and that, in so doing, McGee violated FINRA's rules. Specifically, the Hearing Panel found that McGee: (1) willfully failed to inform CF of the $49,264 in commissions that he received in connection with her purchase of 54Freedom's charitable gift annuity; (2) made an unsuitable recommendation to CF when he proposed that CF surrender the variable annuities and purchase a charitable gift annuity; (3) engaged in undisclosed outside business activities when he failed to provide his firm with written notice of his activities with 54Freedom; (4) failed to timely update his Uniform Application for Securities Industry Registration or Transfer ("Form U4") to disclose that he moved his business office to 54Freedom's premises; and (5) made misrepresentations on his firm's annual compliance questionnaires when he falsely stated that he had disclosed all of his business-related email addresses, and that he was not involved in the offer or sale of any security or investment that the firm did not approve.

The Hearing Panel barred McGee for the fraudulent omission and unsuitable recommendation, and it ordered McGee to pay $236,202.50 in restitution to CF and disgorge his commissions. The Hearing Panel declined to impose sanctions for the three remaining causes of action. After an independent review of the record, we affirm the Hearing Panel's findings and most, but not all, of the sanctions imposed. As discussed later in the decision, we have modified the restitution amount and decided not to order disgorgement.

I. Factual Background

McGee entered the securities industry in January 1988, registering with a firm as a general securities representative. In October 1990, he registered with FINRA as a general securities principal. McGee has been registered with FINRA continuously since January 1988, and he is currently registered with a firm as a general securities representative and principal. During the period relevant to the facts of this case, McGee was registered as a general securities representative and principal with Cadaret, Grant & Co., Inc. McGee joined Cadaret Grant in April 2007. Five years later, in October 2012, Cadaret Grant permitted McGee to resign because of the conduct at issue.

A. McGee Begins Managing CF's Investments

CF was married for 36 years, beginning at age 20. She did very little work outside the home, her husband controlled the family's finances, and she did no investing. She filed for

divorce in the early 1990s. As part of the divorce settlement, CF received cash, money market funds, and the joint accounts that she and her former spouse maintained at the Teachers Insurance and Annuity Association ("TIAA") and College Retirement Equities Fund ("CREF").

CF was unfamiliar with financial matters when she received the divorce settlement, and she asked her accountant for assistance. The accountant recommended that she invest the assets received in the divorce settlement with his son, an individual who was then-registered with a broker-dealer. CF invested the funds with the accountant's son in 1999. The accountant's son serviced CF's account for eight years, until he left the firm in 2007. The firm assigned CF's account to McGee when the accountant's son resigned. In April 2007, McGee took CF's account with him to a new firm, Cadaret Grant. When CF transferred her account to Cadaret Grant, she opened the account with a "long term growth" investment objective and "moderate" risk tolerance.

Between October 2007 and June 2010, while McGee was registered with Cadaret Grant, he recommended that CF purchase four variable annuities, and she did. CF purchased two variable annuities with "The Hartford," and she purchased two variable annuities with Pacific Life Insurance Company. By March 2011, CF's accounts held assets of approximately $842,000. Of this amount, CF had $584,000 in accounts that McGee had recommended or was assigned to: (1) $505,000 through the four Hartford and Pacific Life variable annuities; (2) $67,000 in a Cadaret Grant brokerage account; and (3) $12,000 in a non-traded Cadaret Grant real estate investment trust (REIT). CF also maintained $258,000 in a TIAA account, which was not under McGee's management.

B. McGee Develops a Relationship with 54Freedom's Founder and CEO, James Griffin

In 2008 or 2009, McGee met James Griffin while playing golf. The two men developed a business relationship, and Griffin told McGee about his insurance company, 54Freedom, and 54Freedom's charitable gift annuity program.[1] McGee examined 54Freedom's website, and he read the company's marketing materials. 54Freedom's marketing materials stated that the

[1] Charitable gift annuities are investment products, typically issued through third-party administrators, which enable individuals to transfer cash or marketable securities to charitable organizations. *See NASD Regulatory & Compliance Alert*, Summer 2002 at 26/27, http://www.finra.org/sites/default/files/RCA/p002369.pdf. The charitable organizations, through the administrators, then issue gift annuities to the individuals in exchange for a current income tax deduction and the organization's promise to make fixed annual payments for life. *See id.* At the deaths of the annuitants, the remaining funds are disbursed to the charity. *See id.*; *NASD Notice to Members 02-70*, 2002 NASD LEXIS 84, at *7-8 (Oct. 2002) (explaining that "[a] [c]haritable [g]ift [a]nnuity enables an individual to transfer cash or marketable securities to charitable organizations that then issue gift annuities in exchange for a current income tax deduction and the organization's promise to make fixed annual payments for life. Registered persons may be told that [charitable gift annuities] do not require federal or state securities registration or licensing. This is false, however, if representatives will receive a commission").

company's charitable gift annuity program was a "unique," "patent-pending" investment "solution" that was "unavailable elsewhere." The marketing materials also touted 54Freedom's referral fees and "generous street level compensation." 54Freedom's marketing materials stated that the company's "street level compensation" was eight percent.

By late 2010, the business relationship between McGee and Griffin deepened, and McGee and Griffin proposed to enter into a joint venture. McGee prepared a business plan for the joint venture. McGee proposed that he sell securities products, that Griffin and 54Freedom sell insurance products, and that both men contribute to the opening of a new office on Singer Island, Florida, where Griffin resided. As McGee's and Griffin's joint venture developed, McGee moved his business operations to 54Freedom's premises.[2] Griffin did not charge McGee for the use of 54Freedom's office space.

C. McGee Uses CF's Investment as a "Case Study" for 54Freedom's Charitable Gift Annuity Program

McGee's assistant, Andrew Baker, testified at the hearing. Baker testified that, after McGee moved his business operations to 54Freedom's premises, McGee informed him that he decided to use a customer's investment as a "case study" to "see if [54Freedom's charitable gift annuity program] really work[ed]." McGee told Baker that, if 54Freedom's charitable gift annuity program "worked," McGee would begin incorporating the product into more of his customers' portfolios. McGee's "case study" was CF.

McGee began discussing 54Freedom and the charitable gift annuity program with CF in December 2010. In January 2011 or February 2011, McGee provided CF with 54Freedom's marketing materials. In March 2011, McGee prepared a summary of CF's portfolio and presented CF with the portfolio summary at an in-person meeting at CF's house on March 9, 2011. The portfolio summary noted the total value of CF's four variable annuities, $505,244.78, the cost basis of the variable annuities, $200,000, the anticipated gains associated with the surrender of the variable annuities, $300,000, the estimated taxes due as a result surrendering the variable annuities, $100,000, and the surrender charges that CF would incur if she surrendered the variable annuities, $36,516.60. During the meeting in CF's house, McGee prepared, and CF signed, forms to surrender the four variable annuities.

When CF surrendered the four variable annuities, the actual value of the annuities was $492,642. In the days following McGee's preparation and submission of the variable annuity surrender documents, Hartford and Pacific Life issued checks to CF totaling $454,998.75. The surrender charges on the four variable annuities totaled $36,202.50. The remainder of the funds from the surrender of the variable annuities, $1,440.75, went toward taxes and administrative fees.

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[2] McGee moved into 54Freedom's offices in late 2010 or early 2011. McGee, however, did not notify Cadaret Grant of the move until December 2011. On December 5, 2011, McGee informed Cadaret Grant of his new address, and Cadaret Grant filed an updated Form U4 with FINRA to reflect McGee's address change.

On March 17, 2011, McGee met CF at her house, drove her to the bank, completed deposit slips for the deposit of the surrender checks into CF's checking account, and directed CF to write a check payable to 54Freedom in the amount of $454,998.75. McGee then left with CF's check, and he immediately went to the 54Freedom's office to deliver the funds. McGee did not provide CF with any documentation related to the transaction.

D. McGee Does Not Inform CF of the Compensation He Received for Her Purchase of 54Freedom's Charitable Gift Annuity

In anticipation of CF's receipt of the surrender checks from Hartford and Pacific Life, McGee prepared an analysis reflecting the compensation he expected to receive from 54Freedom for CF's purchase of the charitable gift annuity. He calculated that his compensation for the sale would be $49,264, or 10 percent of the actual value of CF's variable annuities prior to the deduction of the surrender charges. On March 25, 2011, eight days after McGee delivered CF's funds to 54Freedom, 54Freedom provided McGee with a check, signed by Griffin, in the amount of $49,264.[3] McGee testified that he knew that the compensation was for CF's purchase of the 54Freedom charitable gift annuity, and that it was one of the 10 largest commissions of his career. McGee, however, did not inform CF that he expected to receive compensation in connection with her investment with 54Freedom.

E. 54Freedom's Use of CF's Investment

On the day that McGee hand-delivered CF's check to 54Freedom, 54Freedom had only $100 in its account. Between January 2011 and May 2011, the only deposit into 54Freedom's account was CF's check for $454,998.75. Over the next several weeks, Griffin used CF's funds not only to pay McGee, but also to fund several of Griffin's other 54Freedom-affiliated enterprises.

Between April 2011 and May 2011, 54Freedom, through Griffin, began using CF's funds to implement her charitable gift annuity. 54Freedom purchased three Lincoln Financial fixed indexed annuities, totaling $254,998, on behalf of CF. Griffin also made charitable donations of $175,000 to three organizations in CF's name.[4] Each of the "charities" was related to 54Freedom, Griffin, or McGee.

Griffin donated $85,000 to "The American Legion Harvey W. Seeds Post #29," which, in reality, was 54Freedom's call center in Miami, Florida. Griffin also donated $50,000 to

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[3] McGee received an additional $10,000 from 54Freedom, $5,000 in September 2011 and $5,000 in January 2012, based on CF's purchase of the 54Freedom charitable gift annuity.

[4] CF invested $454,998.75 with 54Freedom. Our review of the evidence demonstrates 54Freedom used CF's funds in the following manner: (1) $254,998 for the Lincoln Financial fixed indexed annuities; (2) $175,000 for donations to "charities;" and (3) $49,264 for McGee's compensation. These three amounts total $479,262, which exceeds CF's investment by $24,263.25. The record does not explain this discrepancy.

"Creative Healing Connections," an entity founded by an individual who was McGee's customer and someone with whom McGee and Griffin played golf. Finally, Griffin donated $40,000 to "54Freedom Foundation,"[5] which, in turn, donated $25,000 to the "Blind Children's Center," an entity established by a 54Freedom board member. 54Freedom received 40 to 50 percent of the $175,000 that Griffin disbursed as charitable donations as "finder's fees" for its services.

F. CF Hires an Attorney to Assist Her in Locating McGee and Her Investment with 54Freedom

Between March 2011, when CF gave McGee the funds to purchase the 54Freedom charitable gift annuity, and April 2012, CF testified that McGee provided her with no information concerning her investment with 54Freedom. Accordingly, CF hired an attorney to assist her with communicating with McGee and locating the funds that she had given McGee. CF testified that she hired an attorney "[b]ecause I wasn't getting any answers to what [] McGee had done with my money[,] and it just seemed like something was terribly wrong."[6]

CF's attorney reached McGee in mid-June 2012. On June 18, 2012, McGee sent CF's attorney a letter "[i]n response to your letter dated June 14, 2012 and to follow-up with our phone conversation of this morning . . . ." McGee provided CF's attorney with the contact information of Griffin and a second 54Freedom executive. McGee also summarized the facts surrounding CF's surrender of the variable annuities and purchase of the 54Freedom charitable gift annuity:

> On several occasions[,] while discussing what options [CF] has to choose from[,] she offered to "give" me her money. I declined as I did not[,] nor could not[,] be responsible for same. I recommended she donate to charity to receive tax deductions and introduced her to a local charitable gifting firm, 54Freedom. After this occurred[,] I no longer was involved in any further process of her donations.[7]

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[5] CF's donation was the only donation that 54Freedom Foundation received in 2011.

[6] Correspondence from CF's attorney to CF, dated April 2012, states that CF had a tax liability totaling $16,000 for fiscal year 2011, legal expenses associated with the attorney's efforts to communicate with McGee, and accounting expenses for the preparation of CF's taxes for fiscal year 2011. The attorney's correspondence states that CF needed to communicate with McGee, at a minimum, to have him liquidate a portion of CF's investment with 54Freedom to pay the tax bill and legal and accounting fees.

[7] In December 2010, CF gave McGee two checks, totaling $13,000, made out to "cash." CF testified that McGee stated he needed the funds to assist him with establishing his new business. CF testified that McGee told her that his new business was named 54Freedom.

G. Cadaret Grant's Investigation

CF's attorney was not satisfied with McGee's response, and, on August 1, 2012, he sent a letter to Cadaret Grant's compliance department. The attorney's letter briefly recounted CF's surrender of the variable annuities and purchase of the charitable gift annuity. CF's attorney concluded that "these investments were undertaken with reckless disregard of penalties and/or other losses[,] which might be incurred by my client . . . [and m]y client demands the return of her initial investment and repayment of the penalties[,] which she incurred." Upon receipt of CF's attorney's letter, Cadaret Grant initiated an internal investigation.[8]

On August 13, 2012, the compliance officer made an unannounced visit to McGee's office to ask him about the transaction involving CF and 54Freedom. McGee told the compliance officer that he had done "consulting" work for 54Freedom, but, as far as CF was concerned, he had "handed [her] off to Griffin." The compliance officer was skeptical. As an initial matter, McGee's customer file concerning CF contained documents related to the surrender of the variable annuities and purchase of the 54Freedom charitable gift annuity. Moreover, when the compliance officer asked McGee if he had been paid in relation to CF's transactions, McGee said he had not. But later in that same conversation, McGee acknowledged that he had received a "referral fee" of about $50,000 from 54Freedom. McGee, however, denied that the payment was connected to any specific transaction.[9] After the compliance officer met with McGee about CF and 54Freedom, he "deduce[d] very quickly that there was more involvement than a simple hand-off."[10]

Cadaret Grant permitted McGee to resign. CF's attorney contacted Lincoln Financial, and Lincoln Financial refunded CF $254,998, the amount of the premiums that 54Freedom had paid on behalf of CF for the three fixed indexed annuities. The remainder of CF's original investment with 54Freedom, $200,000, remains unreturned.

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[8] During the course of the internal investigation, Cadaret Grant pulled and reviewed each of the annual compliance questionnaires that McGee completed between 2007 and 2011. On each questionnaire, McGee certified that he had "disclosed all business-related email addresses to Cadaret Grant," and that he had not been "involved in any offers or sales of any security, or any type of investment, whether or not registered with the [Commission] that were not processed through Cadaret Grant . . .without written permission from Cadaret Grant."

[9] McGee provided a similar account of events to his supervisor at Cadaret Grant. McGee told his supervisor that he was paid for "consulting work and marketing" by 54Freedom, but that "he did not receive any compensation directly related to transactions for [CF]."

[10] In notes summarizing his investigation, the compliance officer observed that he had "to repeatedly ask [McGee] the same questions in different ways and at different times" to get him to provide details. The compliance officer also noted that McGee's explanations "were not consistent throughout the interview or in subsequent conversations."

H. Griffin's Indictment and Arrest for Fraud

In July 2015, Griffin was arrested on charges that he engaged in mail fraud, wire fraud, and unlawful monetary transactions to perpetuate the mail fraud and wire fraud.[11] The criminal complaint, alleged that Griffin and his 54Freedom enterprises fraudulently induced investors to purchase 54Freedom's charitable gift annuities by misrepresenting that the annuities would be issued by a highly-rated, major insurance carrier, and the annuity, which was a pivotal feature of the charitable gift annuity package, would provide investors with guaranteed lifetime income. The criminal complaint also alleged that Griffin converted the $1.6 million in funds that he received from the purchasers of 54Freedom charitable gift annuities to pay personal expenses and 54Freedom's liabilities. Griffin has been released on bond, subject to certain conditions, and the criminal proceeding is pending.

One week after Griffin's federal criminal indictment and arrest, the Commission filed a follow-on federal civil action in federal court.[12] The Commission's complaint alleged that Griffin, 54Freedom's Chief Financial Officer, the 54Freedom enterprises, and Griffin's wife raised at least $8 million from at least 125 investors through the offer and sale of 54Freedom's shares, promissory notes, and charitable gift annuities.[13] Specifically, the Commission asserted that Griffin and the other defendants,

> [F]raudulently induced individual investors to purchase 54Freedom securities – i.e., its stock, promissory notes[,] and "charitable gift annuities" – with materially false and misleading oral and written projections and promises regarding 54Freedom share price increases, stock listings, revenue projections, the safety of the securities, and 54Freedom's use of investor proceeds. Defendant James Griffin created and controlled 54Freedom and orchestrated the fraud.

The Commission's federal civil action has been stayed pending the resolution of Griffin's federal criminal case.

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11 *U.S. v. Griffin*, Criminal Docket No. 5:15-cr-00207-FJS (N.D.N.Y., Filed July 22, 2015).

12 *SEC v. Griffin*, Civil Docket No. 5:15-cv-00927-FJS (N.D.N.Y., Filed July 30, 2015).

13 With respect to 54Freedom's charitable gift annuity, the product that CF purchased, the Commission's complaint states that 54Freedom marketed and sold $2 million in charitable gift annuities to 16 investors and paid only $30,000 in annuity payments to the investors. The Commission's complaint also states that, "Griffin and 54Freedom misappropriated nearly $1.5 million of the $2 million entrusted to the 54Freedom Foundation by the [charitable gift annuity] investors."

II. Procedural History

FINRA's Department of Enforcement initiated its investigation of this matter when Cadaret Grant filed McGee's Uniform Termination Notice for Securities Industry Registration ("Form U5") with FINRA in October 2012. McGee's Form U5 stated that Cadaret Grant had permitted McGee to resign for "fail[ing] to disclose an outside business activity in violation of firm policies and procedures."

In November 2013, Enforcement filed a five-count complaint against McGee. The first cause of action alleged that McGee violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010 because he willfully engaged in securities fraud in two aspects.[14] First, Enforcement argued that McGee misrepresented a material fact when he allegedly told CF that she was facing a large tax liability and needed to make charitable donations to offset that tax liability, and, second, McGee omitted a material fact when he failed to inform CF of the compensation he received in connection with her purchase of the 54Freedom charitable gift annuity.

The second cause of action alleged that McGee violated NASD Rule 2310, NASD IM-2310-2, and FINRA Rule 2010 because his recommendation that CF surrender the variable annuities and purchase the charitable gift annuity was unsuitable. The third cause of action alleged that McGee violated FINRA Rules 3270 and 2010 because he engaged in undisclosed outside business activities through his business relationship with 54Freedom. The fourth cause of action alleged that McGee violated Article V, Section 2(c) of FINRA's By-Laws and FINRA Rules 1122 and 2010 because he willfully failed to timely update his Form U4 to reflect that he moved his office to 54Freedom's premises. The fifth cause of action alleged that McGee violated NASD Rule 2110 and FINRA Rule 2010 because he provided false information to Cadaret Grant when he submitted five annual compliance questionnaires, in which he misrepresented that he had disclosed all of his business-related email addresses, and that he had not been involved in the offer or sale of any unapproved investment product.

A five-day hearing took place in Syracuse, New York, in June 2014. Nine witnesses testified at the hearing, including McGee, CF, a FINRA examiner, five individuals who were registered with Cadaret Grant, and an individual who co-managed CF's account with McGee at McGee's prior firm. The Hearing Panel issued its decision in December 2014, affirming the allegations of the complaint in all but one respect. The Hearing Panel determined that a preponderance of the evidence failed to establish that McGee represented to CF that she faced a tax liability, and that she needed the charitable deductions to offset that tax liability. The Hearing Panel dismissed the portion of the complaint related to CF's purported tax liability. The Hearing Panel barred McGee for failing to inform CF of his compensation from 54Freedom and making unsuitable recommendations to CF and ordered McGee to pay restitution to CF and disgorge the commissions that he had earned from CF's purchase of the charitable gift annuity. The Hearing Panel assessed, but declined to impose, sanctions for engaging in undisclosed

[14] We discuss the rules in effect when the conduct occurred.

outside business activities, willfully failing to timely update his Form U4, and providing false information to his firm on the compliance questionnaires. This appeal followed.

III. Discussion

As explained below, we affirm the Hearing Panel's findings for each of the five causes of action.

A. McGee Engaged in Fraud, in Violation of the Exchange Act and FINRA's Rules

The Hearing Panel found that McGee omitted a material fact, i.e., his compensation from 54Freedom, in connection with CF's surrender of the Hartford and Pacific Life variable annuities and purchase of the 54Freedom charitable gift annuity.[15] The Hearing Panel also determined that McGee acted with scienter when he failed to inform CF of his compensation from 54Freedom. The Hearing Panel concluded that McGee's failure to disclose his 54Freedom compensation to CF constituted securities fraud, and that it was a willful violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010. We affirm the Hearing Panel's findings.

1. Fraud Under the Exchange Act

Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 prohibit fraudulent and deceptive acts and practices in connection with the purchase or sale of a security. Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b).

In this case, the Hearing Panel found, and we agree, that McGee failed to disclose his compensation from 54Freedom, in violation of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. To establish a violation of these antifraud provisions, a preponderance of the evidence must demonstrate that: (1) McGee "made . . . a material omission if [he] had a duty to speak;" (2) McGee made the material omission "in connection with the purchase or sale of a security;" and (3) McGee "act[ed] with scienter" when he made the material omission.[16] *SEC v.*

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[15] Neither party requested our review of the Hearing Panel's dismissal of the fraud, as it related to McGee's alleged representations to CF concerning her tax liability and the necessity of charitable deductions to offset that liability. On appeal, we decline to exercise our discretion to review a finding that neither party appealed.

[16] Liability under Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 also requires proof that McGee used "means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange." 17 C.F.R. § 240.10b-5. The jurisdictional element of the case is satisfied because McGee communicated with CF via telephone, sent CF's surrender forms to Hartford via US mail, and sent her surrender forms to Pacific Life via facsimile. *See SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 865 (S.D.N.Y. 1997)

[Footnote continued on next page]

First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996); *see also William Scholander*, Exchange Act Release No. 77492, 2016 SEC LEXIS 1209, at *14 (Mar. 31, 2016) (explaining that securities fraud is established when the applicants "used any means or instrumentality of interstate commerce or of the mails . . . to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . with scienter . . . in connection with the purchase or sale of securities"). We discuss each element in turn.

a. McGee Made a Material Omission When He Had a Duty to Speak

McGee failed to inform CF of the compensation that he received from 54Freedom for her purchase of the company's charitable gift annuity. It is undisputed that McGee did not tell her about the compensation before she surrendered the Hartford and Pacific Life variable annuities and purchased the 54Freedom charitable gift annuity, and McGee did not inform her of the compensation after he received it from 54Freedom.

(i) Duty to Speak

Liability for failing to disclose material information is "premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Chiarella v. United States*, 445 U.S. 222, 230 (1980). "A registered representative owes such a duty to his clients to disclose material information fully and completely when recommending an investment." *Dep't of Mkt. Regulation v. Burch*, Complaint No. 2005000324301, 2011 FINRA Discip. LEXIS 16, at *23 (FINRA NAC July 28, 2011). When a registered representative recommends a security to a customer, the representative has a duty to speak and "must disclose material adverse facts of which [he] is aware," including "adverse interests such as economic self interest that could have influenced [the] recommendation." *Richmark Capital Corp.*, 57 S.E.C. 1, 9 (2003); *see Scholander*, 2016 SEC LEXIS 1209, at *17-22. McGee had an affirmative duty to speak and disclose his 54Freedom compensation to CF because he recommended that CF surrender the Hartford and Pacific Life variable annuities and purchase the 54Freedom charitable gift annuity.

In the proceedings below, McGee, Enforcement, and the Hearing Panel each agreed that the issue of whether McGee had "recommended" that CF surrender the variable annuities, and purchase of the charitable gift annuity, was at the "core" of the disciplinary action because, without the recommendation, the allegations related to the fraud, and, as discussed later, the suitability violations necessarily must fail. We agree.

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(determining that the jurisdictional requirements of the federal antifraud provisions are interpreted broadly and are satisfied by intrastate telephone calls or the use of the US mail), *aff'd*, 159 F.3d 1348 (2d Cir. 1998) (Table).

As he did in the proceedings below, McGee asserts on appeal that he did not recommend that CF surrender the Hartford and Pacific Life variable annuities, and that he did not recommend that CF purchase the 54Freedom charitable gift annuity. Rather, McGee asserts that the idea of surrendering the variable annuities originated with CF. McGee testified that he learned that some of CF's familial relationships had soured, and that she wanted to identify investment alternatives for her estate. McGee stated that he recommended that CF speak to an expert in charitable giving, and that she reach out to Griffin about 54Freedom. McGee stated that he provided CF with Griffin's telephone number, and that he "left [it] in her hands."

According to McGee, on March 7, 2011, CF called him to arrange an in-person meeting at her house two days later. McGee testified that, when he met with CF at her house on March 9, 2011, CF announced, for the first time, that she had talked to Griffin, and that she wanted to sell her variable annuities and invest the proceeds with 54Freedom. McGee stated that CF was "adamant" about selling the variable annuities. McGee testified that he objected to CF's proposed surrender of the variable annuities, pointed out the flaws with the surrender of the policies, and offered CF several alternatives to selling them. According to McGee, CF rejected his alternatives, and she insisted that he process the sale.

McGee similarly denied that he recommended that CF purchase the 54Freedom charitable gift annuity. McGee testified that CF and Griffin had spoken prior to McGee's meeting with CF at her house on March 9, 2011, but he did not know whether Griffin had recommended that CF purchase the 54Freedom charitable gift annuity. McGee also testified that he was not promised any type of compensation for introducing a customer to Griffin or 54Freedom, and that he had no agreement with Griffin or 54Freedom to receive any type of referral compensation.

Despite the myriad of misgivings that McGee expressed about CF's surrender of the variable annuities and purchase of the charitable gift annuity, McGee nevertheless processed CF's transactions. When asked why he did so, McGee testified that he was required to comply with CF's request because she was his "client," and she was "mad" about her deteriorating familial situation. McGee's depiction of the events leading up to CF's surrender of the variable annuities and purchase of the charitable gift annuity defy logic, the Hearing Panel's well-supported credibility determinations, and the overwhelming breadth of the documentary evidence and witness testimony.

The Hearing Panel determined that McGee's version of events was not credible, and it relied on the testimony of other witnesses, such as McGee's assistant, Baker, and the documentary evidence in the record to find that McGee recommended that CF surrender the two Hartford variable annuities, surrender the two Pacific Life variable annuities, and purchase the 54Freedom charitable gift annuity. On appeal, McGee offers us no evidence to overturn the Hearing Panel's credibility determinations.[17] *See Dep't of Enforcement v. Davidofsky*,

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[17] Although the Hearing Panel determined that McGee's version of events was not credible, we acknowledge that the Hearing Panel also found that the testimony of CF also was not reliable in certain respects. We therefore relied on the documentary evidence in the record, McGee's own admissions, and Baker's testimony to inform our review of this appeal. With regard to

[Footnote continued on next page]

Complaint No. 2008015934801, 2013 FINRA Discip. LEXIS 7, at *22 (FINRA NAC April 26, 2013) ("[C]redibility 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 and can be overcome only where the record contains substantial evidence for doing so.").

The evidence shows that it was McGee's goal, from even his most preliminary discussions with CF about 54Freedom in December 2011, to have CF purchase a 54Freedom charitable gift annuity. The surrender of the variable annuities was a preliminary, albeit necessary, step for CF to obtain sufficient funds to purchase the charitable gift annuity. The development of McGee's business relationship with Griffin and 54Freedom solidify these facts and demonstrate that McGee's primary interest was not in dealing candidly with CF, but rather, to gird his economically beneficial relationship with Griffin and 54Freedom.

McGee met Griffin in 2008 or 2009.[18] By late 2010, McGee and Griffin proposed to enter into a joint venture, McGee prepared a business plan to initiate the joint venture, and McGee moved his business operations to 54Freedom's offices. Around this same time, McGee began discussing the use of a customer's assets as a "case study" to determine whether 54Freedom "worked," and McGee approached CF about 54Freedom and the company's charitable gift annuity program. In addition, although the events giving rise to it remain unclear, in December 2010, CF gave McGee $13,000 to assist him with a new business, which he had identified to her as 54Freedom. By January 2011 or February 2011, McGee had provided CF with 54Freedom's marketing materials, and, by March 2011, CF had purchased a 54Freedom charitable gift annuity for $454,998.75. McGee's deepening business relationship with Griffin and 54Freedom throughout late 2010 and early 2011 and the other preparatory acts of McGee lead us to conclude that McGee recommended that CF purchase the 54Freedom charitable gift annuity, and that he recommended that she surrender the variable annuities to facilitate the subsequent charitable gift annuity purchase.[19]

[cont'd]

Baker, the Hearing Panel determined that his "recollection was clear, and there was no evidence of a motive for him to be untruthful or biased against McGee, with whom he still works and shares clients." McGee also testified that Baker was a "truthful" individual, and McGee did not directly dispute Baker's testimony. Rather, McGee stated that he was unable to recall several of the key events that transpired in this case. We, similar to the Hearing Panel, have looked to Baker's testimony to corroborate the documentary and testimony evidence contained in the record.

[18] CF's first, and only, contact with 54Freedom occurred when Griffin telephoned her in January 2012, nearly one year after she had purchased the 54Freedom charitable gift annuity.

[19] For example, when McGee met with CF on March 9, 2011, he had with him all the forms necessary for CF to surrender the Hartford and Pacific Life variable annuities. McGee testified that it was his normal practice to carry a booklet of forms with him to every customer meeting because he spent a significant amount of time out of the office visiting customers. It seems, however, implausibly coincidental that McGee happened to have with him the precise forms

[Footnote continued on next page]

(ii) Materiality

An omitted fact is "material" if there is a substantial likelihood that a reasonable investor would have considered the omitted fact important in making an investment decision, and "disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). McGee's omission, his compensation from 54Freedom, was a material fact in the context of his recommendation that CF purchase a 54Freedom charitable gift annuity. Indeed, a reasonable investor would have considered 54Freedom's payment to McGee as an important factor to evaluate McGee's recommendation to invest funds with the company. *See, e.g., Scholander*, 2016 SEC LEXIS 1209, at *16-22 (applicants' receipt of $350,000 from the issuer of a security constituted a "material adverse fact[]," which the applicants were required to disclose to customers to whom they recommended the purchase of the security).

At a minimum, the $50,000 payment that McGee received from 54Freedom had the potential to influence McGee's recommendation of 54Freedom's investment products, including its charitable gift annuity to CF. *See id.* at *20-21 (stating that the applicants' receipt of funds from the issuer "casts doubt on the sincerity of [a]pplicants' recommendation to buy [the issuer's] stock"). "When recommending securities to a prospective investor, a securities professional must not only avoid affirmative misstatements but also must disclose 'material adverse facts,' including any self-interest that could influence the salesman's recommendation." *Id.* at *16 (quoting *Richard H. Morrow*, 53 S.E.C. 772, 781 (1998)). Investors, therefore, "must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest." *Id.* at *16-17 (quoting *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171-72 (2d Cir. 1970)). As the Commission recently summarized in *Scholander*,

> When a broker-dealer has a self-interest (other than the regular expectation of a commission) in serving the issuer that could influence its recommendation, it is material and should be disclosed. The failure to disclose the . . . payment is, on its own, sufficient to support FINRA's finding of fraud. Applicants' failure to disclose their business relationship with [the issuer] also violated their duty to disclose a conflict of interest to their customers.

Id. (internal quotation marks omitted).

McGee's 54Freedom compensation was "other than the regular expect[ed] . . . commission." *Id.* As an initial matter, the compensation came from the issuer, 54Freedom. Second, the basis of McGee's compensation was not the purchase price of CF's charitable gift

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[cont'd]

necessary for CF to surrender variable annuities from Hartford and Pacific Life, when he claimed to have had no advance notice that CF was planning to do so.

annuity. Rather, it was based on the value of CF's variable annuities prior to their surrender. Third, 54Freedom also paid McGee's compensation in three parts. McGee received $49,264 in March 2011, $5,000 in September 2011, and $5,000 in January 2012, for total compensation of $59,264. Finally, McGee's compensation from 54Freedom provided McGee with an economic self-interest and created a potential conflict of interest. McGee was required to disclose his compensation from 54Freedom when he recommended that CF surrender the variable annuities to purchase the 54Freedom charitable gift annuity. His failure to make that requisite disclosure constituted an omission of material fact. *See id.*

b. McGee Made the Material Omission in Connection with the Purchase or Sale of a Security

McGee also made the material omission, the compensation that he earned for CF's purchase of the 54Freedom charitable gift annuity, in connection with the purchase or sale of a security. On appeal, McGee argues that 54Freedom purchased Lincoln Financial fixed indexed annuities on behalf of CF, fixed indexed annuities are not securities, and, consequently, he could not have engaged in securities fraud. McGee's arguments miss their intended mark for three reasons. First, McGee's arguments too narrowly construe the phrase, "in connection with the purchase or sale of any security," as it is used in Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. Second, McGee's arguments ignore part one of the two-part strategy that he implemented for CF's investment with 54Freedom – CF's surrender of the Hartford and Pacific Life variable annuities, variable annuities that are securities within the meaning of the federal securities laws. And third, McGee's arguments ignore the fact that he recommended and sold CF a 54Freedom charitable gift annuity, not a Lincoln Financial fixed indexed annuity, and 54Freedom's charitable gift annuities constitute securities within the meaning of the federal securities laws.

(i) The "in Connection with" Requirement Should Be Interpreted Broadly

McGee's reading of the "in connection with the purchase or sale of any security" is far too narrow. Congress's objectives in promulgating the Exchange Act was to ensure honest securities markets and promote investor confidence. *See SEC v. Zandford*, 535 U.S. 813, 819 (2002) (citing *United States v. O'Hagan*, 521 U.S. 642, 658 (1997)). Accordingly, Congress sought "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *Zandford*, 535 U.S. at 819 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)). To effectuate its remedial purposes, the Exchange Act should be construed flexibly, not technically and restrictively. *Zandford*, 535 U.S. at 819 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)). Consistent with the remedial purposes of the Exchange Act, the Supreme Court has adopted a broad reading of "in connection with the purchase or sale of any security," as used in Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. *Zandford*, 535 U.S. at 819.

When interpreting the "in connection with the purchase or sale of any security" language, the Supreme Court has determined that it is sufficient for the material misrepresentation or

material omission to "touch" or "coincide" with the purchase or sale of a security. *See Zandford*, 535 U.S. at 822 ("It is enough that the scheme to defraud and the sale of securities coincide."); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 85 (2006) ("Under our precedents, it is enough that the fraud alleged 'coincide' with a securities transaction"); *Superintendent of Ins. of NY v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971) (holding that the "in connection with" requirement is satisfied where the customer's harm occurred "as a result of deceptive practices touching [a] sale of securities"). The Supreme Court also has held that a security involved in only one side of a transaction is sufficient. *See Zandford*, 535 U.S. at 820-22. In *Zanford*, for example, the Supreme Court determined that a registered representative engaged in securities fraud, in violation of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, when the representative convinced a customer to surrender his securities, and then converted the customers' proceeds from the securities sale. *See id*.

In this case, McGee implemented a two-part strategy and failed to disclose his compensation from 54Freedom, in connection with the purchase *and* sale of a security. Part one of the strategy, CF's surrender of the variable annuities, was a necessary first step for McGee to obtain the funds needed to implement part two of the strategy, CF's purchase of the 54Freedom charitable gift annuity. Each part of the two-part strategy was connected to the purchase or sale of a security, i.e., variable annuities, on the one side, and charitable gift annuities, on the other side.[20]

(ii) Variable Annuities Are Securities

"A variable annuity is an investment product sold by life insurance companies." *Michael A. Horowitz*, Initial Decisions Release No. 733, 2015 SEC LEXIS 43, at *5 (Jan. 7, 2015). The owner of a variable annuity initially invests a sum of money in the annuity, and, subsequently, chooses how to distribute those sums among various sub-accounts, similar to a mutual fund. *See id.* at *5. "A variable annuity is a 'security' within the meaning of the federal securities law." *Horowitz*, 2015 SEC LEXIS 43, at *61 (Jan. 7, 2015); *see SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 67-73 (1959) ("[A]bsent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interests reflects – which may be a lot, a little, or nothing."); *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 109 (2d Cir. 2001) (explaining that the Supreme Court "conclusively" resolved the question of whether a variable annuity is a security, and stating that, "the [Supreme] Court considered whether variable annuities must be registered as securities . . . [and] the Supreme Court held that . . . variable annuities are properly classified as securities and thus subject to the federal securities statutes. Thus . . . the [Supreme] Court held that variable annuity contracts are in fact securities.").

(iii) 54Freedom's Charitable Gift Annuities Are Securities

Unlike variable annuities, which the Supreme Court has conclusively defined as a security under the federal securities laws, charitable gift annuities present a hybrid investment product, and, consequently, courts differ as to whether all charitable gift annuities are securities

[20] Either of these findings serve as a basis to find that McGee engaged in fraud.

within the meaning of the federal securities laws. *Compare Warfield v. Alaniz*, 569 F.3d 1015, 1020-1024 (9th Cir. 2009) (finding that charitable gift annuities are securities within the meaning of the federal securities laws), *with Riniker v. Locust St. Sec., Inc.*, 2006 Iowa App. LEXIS 1716, at *6 (Iowa Ct. App. May 10, 2006) (finding that charitable gift annuities are not securities within the federal securities). We therefore examine and apply the fact-specific "investment contracts" framework, articulated in *SEC v. W.J. Howey*, 328 U.S. 293 (1946), to determine whether 54Freedom's charitable gift annuities constituted securities within the meaning of the federal securities laws.[21] *See, e.g.*, *Warfield*, 569 F.3d at 1020 (applying the *Howey* investment contracts test to examine whether charitable gift annuities are securities); *SEC v. Bennett*, 904 F. Supp. 435, 436-37 (E.D. Pa. 1995) (same).

To determine whether a particular investment product is a security, a preponderance of the evidence must demonstrate that the investment product involved: (1) "an investment of money;" (2) "in a common enterprise;" (3) "with a reasonable expectation by the investors of profits;" (4) "to be derived from the managerial efforts of others." *Howey*, 328 U.S. at 301; *Warfield*, 453 F. Supp. 2d at 1124 (enumerating the *Howey* factors), *aff'd*, 569 F.3d 1015 (9th Cir. 2009). When applying *Howey*, the Supreme Court cautioned that the test should be "broadly construed by [] courts so as to afford the investing public a full measure of protection[, and that form should be] disregarded for substance and emphasis was placed upon economic reality." *Howey*, 328 U.S. at 298. The Supreme Court underscored this point and stated that the term, security, "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299.

(a) Investment of Money

The first factor in the *Howey* investments contracts analysis examines whether there is an investment of money. There is an "investment of money" when an investor provides "some tangible and definable consideration in return for an interest that had substantially the characteristics of a security." *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559-560 (1979)); *see also Warfield*, 569 F.3d at 1021 (explaining that the key question on the "investment of money" prong is whether the investor "commit[s] his assets to the enterprise in such a manner as to subject himself to financial loss"). CF made an investment of money to satisfy the first prong of the *Howey* analysis because she purchased the 54Freedom charitable gift annuity by

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[21] The definition of a "security" within the federal securities laws covers a broad range of transactions. *See Warfield v. Alaniz*, 453 F. Supp. 2d 1118, 1123 (D. Ariz. 2006) (noting that Congress's purpose in enacting the federal securities laws was to regulate investments "regardless of the form they take or the name that they are called"). Although charitable gift annuities are not enumerated among the investment products identified as securities in the federal securities laws, the specified term, "investment contract," has been identified as a catch-all provision to determine whether a particular investment product meets the definition of a security. *See* Louis Loss & Joel Seligman, *Securities Regulations*, § 3-A-1(a)(i) (3d ed. 2006).

surrendering four variable annuities, obtaining the proceeds from the annuities in cash, and remitting the cash to 54Freedom by way of McGee.[22]

(b) Common Enterprise

The second factor in the *Howey* investments contracts analysis examines whether there is a "common enterprise."[23] Courts have established three distinct tests for whether a common enterprise exists: "horizontal" commonality, "broad vertical" commonality, and "strict" or "narrow" vertical commonality. All three types of commonality exist here.

Horizontal commonality existed because 54Freedom pooled investors' funds in its bank accounts. *See SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996) (explaining that horizontal commonality is "defined by the pooling of investment funds, shared profits, and shared losses."); *Clifton*, 2013 SEC LEXIS 2022, at *32 n.55 (indicating that a "pooling of interests among more than one investor" would suffice to demonstrate a common enterprise). Broad vertical commonality existed because CF, similar to the other purchasers of 54Freedom's charitable gift annuities, played no part in how 54Freedom handled their investments. *See SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 732 (11th Cir. 2005) (explaining that broad vertical commonality exists where the investors depend on "the expertise or efforts of the investment promoter for their returns"). Finally, strict, also known as narrow, vertical commonality existed in this case because the investors' profits or losses from their investments in 54Freedom depended on the success or failure of 54Freedom. *See Mordaunt v. Incomco*, 686 F.2d 815, 817 (9th Cir. 1982) (asserting that strict vertical commonality requires proof that there is a direct relationship between the success or failure of the promoter and that of the investors); *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973) (stating that strict vertical commonality exists where the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties").

(c) Expectation of Profits

The third factor in the *Howey* investments contracts analysis examines whether the investors had a reasonable expectation of profits. Investors are led to expect "profits" when they are led to expect income or return, including, for example, dividends, other periodic payments, or the increased value of the investment. *See SEC v. Edwards*, 540 U.S. 389, 394 (2004) (noting that "investments pitched as low-risk (such as those offering a 'guaranteed' fixed return) are particularly attractive to individuals more vulnerable to investment fraud"). The examination of

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[22] Hartford and Pacific Life sent CF four checks, representing the surrender value of each of the four variable annuities. On the day that CF purchased the 54Freedom charitable gift annuity, McGee drove her to the bank, where she deposited the four checks into her checking account, and wrote a single check payable to 54Freedom.

[23] The Commission has held that a "common enterprise" is "not a distinct requirement under *Howey*." *Johnny Clifton*, Exchange Act Release No. 69982, 2013 SEC LEXIS 2022, at *32 n.55 (July 12, 2013).

whether an investor has a reasonable expectation of profits is an objective standard based on what the purchasers were led to expect. *See Warfield*, 569 F.3d at 1020-22. As 54Freedom's marketing materials touted,

> The 54Freedom Program . . . [c]reates a tax deduction through a charitable contribution, which allows the individual or married person to mitigate any taxable events while creating a better balanced portfolio[, and] . . . [n]ot only increases assets for the estate and future generations[,] but creates a charitable donation legacy for the family, including the opportunity to "Live the Gift."

The investors in 54Freedom's charitable gift annuity program expected to receive income tax deductions and periodic, fixed streams of income for life, which, collectively, constitute profits for purposes of the *Howey* investment contracts test. *See Warfield*, 453 F. Supp. 2d at 1124 n.4 (stating that, "the investors clearly expected a return on their investment in the form of annuity payments, tax benefits, and at the investors death, the return of the gift to a charity or charities designated by that investor").

(d) Managerial Efforts of Others

The final factor of the *Howey* investment contracts test, which examines whether the profits are "the product of the efforts of a person other than the investor," is also satisfied. *Warfield*, 569 F.3d at 1021. CF had no involvement in the management of 54Freedom, the funds they invested with the company, or the "charitable organizations," with which the company had affiliations. Because the *Howey* investment contracts test is satisfied,[24] we find that the 54Freedom charitable gift annuity constitutes a security within the meaning of the Exchange Act.[25] Having determined that McGee made a material omission when he had a duty to speak, and that McGee made the material omission in connection with the purchase and sale of securities, we turn to the final factor of our fraud analysis, whether McGee acted with scienter when he made the material omission.

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[24] On appeal, McGee asserts that the Lincoln Financial fixed indexed annuities, which 54Freedom purchased on behalf of CF as part of her charitable gift annuity package, are not securities. Because we have determined that McGee recommended and sold CF a 54Freedom charitable gift annuity, and not a Lincoln Financial fixed indexed annuity, we need not reach the issue of whether fixed indexed annuities constitute securities within the meaning of the federal securities laws.

[25] Although our independent application of the *Howey* investment contract test leads us to conclude that the 54Freedom charitable gift annuity that CF purchased was, in fact, a security, we note that the Commission has reached the same conclusion concerning the same product. *See, e.g.*, *Pamela S. Smith*, Exchange Act Release No. 75565, 2015 SEC LEXIS 3152, at *3-5 (July 30, 2015) (barring insurance agent for material misrepresentations, unsuitable recommendations, unregistered securities sales, and sales as an unregistered securities representative in connection with her sales of 54Freedom charitable gift annuities to customers).

c. McGee Acted with Scienter

Scienter is "'a mental state embracing intent to deceive, manipulate, or defraud.'" *Scholander*, 2016 SEC LEXIS 1209, at *22 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976)). Scienter includes recklessness, which is conduct that constitutes "an extreme departure from the standards of ordinary care . . . to the extent that the danger [of deceiving investors] was either known to the [applicant] or so obvious that the [applicant] must have been aware of it." *Scholander*, 2016 SEC LEXIS 1209, at *22. At a minimum, McGee acted recklessly when he failed to inform CF of the $50,000 in compensation that he received from 54Freedom for her purchase of the 54Freedom charitable gift annuity. *See, e.g.*, *id.* at *22-26 (finding that the applicants "acted at least recklessly" and with the requisite scienter, when they recommended that customers purchase an issuer's shares without disclosing to those customers that the issuer had paid them a few months earlier).

On appeal, McGee argues that he did not act with scienter because he did not identify CF as a "case study" for the 54Freedom charitable gift annuity, he had no financial incentive for CF to surrender her variable annuities because he earned no compensation on the liquidations, and he did not have any economic motive to engage in the conduct. McGee stresses that his compensation from 54Freedom "could have in fact been zero," and that, "it would have been more profitable to . . . McGee to keep the assets and the [variable annuities] under his control." The evidence, however, does not support McGee's arguments.

McGee had an established business relationship with Griffin and 54Freedom that made him privy to the substantial compensation that awaited him after he made the sale of the charitable gift annuity to CF. By March 2011, when CF purchased the 54Freedom charitable gift annuity, McGee had known Griffin for three years, and he had developed a sufficient business relationship with Griffin to relocate his business operations to a rent-free office space on 54Freedom's premises and propose a joint business venture with Griffin and 54Freedom. The 54Freedom marketing materials that McGee provided to CF also informed sales personnel that the company provided "generous street level compensation" of at least eight percent. Finally, we turn to the events of March 9, 2011, the date that CF surrendered the variable annuities, and we note, once again, that McGee had the specific forms on hand necessary for CF to surrender the Hartford and Pacific Life variable annuities. McGee's relationship with Griffin and 54Freedom, 54Freedom's marketing materials, and the events of March 9, 2011, demonstrate that McGee knew that compensation awaited him after he sold a 54Freedom product to CF. McGee's failure to inform CF of this compensation constituted a highly unreasonable omission that presented a danger of misleading CF. *See Scholander*, 2016 SEC LEXIS 1209, at *17 (explaining that the applicants' failure to disclose a payment from an issuer constituted fraud).

The record in this case establishes that: (1) McGee made a material omission when he had a duty to speak, (2) McGee made the material omission in connection with the purchase or sale of a security, and (3) McGee acted with scienter when he made the material omission. *See First Jersey Sec.*, 101 F.3d at 1467. We therefore affirm the Hearing Panel's findings that

McGee engaged in securities fraud and willfully violated Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.[26]

2. Fraud Under FINRA's Rules

FINRA Rule 2020 is FINRA's antifraud rule. It is similar to, yet, broader than, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.[27] *See Dep't of Enforcement v. Fillet*, Complaint No. 2008011762801, 2013 FINRA Discip. LEXIS 26, at *38 (FINRA NAC Oct. 2, 2013) (explaining that FINRA Rule 2020 captures a broader range of activity than Exchange Act Rule 10b-5), *aff'd in relevant part*, Exchange Act Release No. 75054, 2015 SEC LEXIS 2142, at *1 (May 27, 2015). FINRA Rule 2020 prohibits members from "effect[ing] any transaction in, or induc[ing] the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

McGee, as a registered representative, had a duty to disclose all material facts related to CF's surrender of the variable annuities and purchase of the 54Freedom charitable gift annuity, particularly the information concerning the unusually large compensation that he received from the company. *See Fillet*, 2015 SEC LEXIS 2142, at *32-33 (holding that the omission of material information, including material adverse facts, from an investor violates FINRA's antifraud rule). McGee violated this duty. McGee knew that his sale of the 54Freedom charitable gift annuity to CF would result in compensation to him, but he purposely withheld this material information from CF. McGee, acting with scienter, induced CF to surrender her variable annuities and purchase a 54Freedom charitable gift annuity by means of fraud and deception, in violation of FINRA Rule 2020. *See id.*; *Scholander*, 2016 SEC LEXIS 1209, at *15 (stating that, "[a] violation of Exchange Act Section 10(b) also constitutes a violation of FINRA Rule 2020, which prohibits FINRA members from 'effect[ing] any transaction in, or

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[26] McGee's willful violation of Section 10(b) of the Exchange Act and Exchange Act 10b-5 results in his statutory disqualification. *See Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) ("'[W]illfully' in [the Exchange Act] means intentionally committing the act which constitutes the violation," not that "the actor [must] also be aware that he is violating one of the Rules or Acts."); *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 SEC LEXIS 558, at *3 n.2 (Feb. 13, 2015) (stating that applicants were statutorily disqualified because they willfully violated Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5); *see also* Sections 3(a)(39)(F) (15 U.S.C. § 78c(a)(39)(F)) and 15(b)(4)(D) (15 U.S.C. § 78o(b)(4)(D)) of the Exchange Act; Article III, Section 4 of FINRA's By-Laws.

[27] Conduct that violates the Commission's or FINRA's rules, including the antifraud rules, is inconsistent with "high standards of commercial honor and just and equitable principles of trade" and violates FINRA Rule 2010. *See Scholander*, 2016 SEC LEXIS 1209, at *15-16. FINRA Rule 2010, which generally apply to FINRA "members," is applicable to associated persons pursuant to FINRA Rule 0140(a).

induc[ing] the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance'").[28]

B. McGee's Recommendation That CF Surrender the Variable Annuities and Purchase the Charitable Gift Annuity Was Unsuitable

The Hearing Panel found that McGee made an unsuitable recommendation to CF when he recommended that she surrender the Hartford and Pacific Life variable annuities to purchase the 54Freedom charitable gift annuity. The Hearing Panel concluded that McGee's recommendation to CF lacked customer-specific and reasonable basis suitability, in violation of NASD Rule 2310, NASD Interpretative Material ("IM") 2310-2, and FINRA Rule 2010. We affirm the Hearing Panel's findings.

When recommending the purchase, sale, or exchange of any security, NASD Rule 2310 required registered representatives, such as McGee, to "have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." NASD Rule 2310(a). NASD IM-2310-2 explained that, "[i]mplicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of [FINRA's r]ules, with particular emphasis on the requirement to deal fairly with the public." NASD IM-2310-2(a)(1).[29] McGee's investment recommendations resulting in CF's surrender of the variable annuities and purchase of the 54Freedom charitable gift annuity failed CF, and they demonstrate that McGee did not meet the standards necessary to satisfy customer-specific or reasonable basis suitability in this case.[30]

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[28] McGee states that he did not engage in fraud because neither Cadaret Grant nor CF's attorney found that he engaged in fraud. Cadaret Grant's and CF's attorney's investigations of this matter, however, are irrelevant. *Cf. Dep't of Enforcement v. Taylor*, Complaint No. C8A050027, 2007 NASD Discip. LEXIS 11, *29 n.15 (NASD NAC Feb. 27, 2007) (explaining that FINRA "is not bound by" another adjudicator's investigation or findings, and that FINRA's investigations and disciplinary actions are independent of other investigations or adjudications). We, not Cadaret Grant or CF's attorney, have been tasked with the determination of whether McGee failed to disclose his compensation to CF, engaged in fraud, and violated the Commission's and FINRA's antifraud rules. We have made that determination.

[29] NASD Rule 2310 and NASD IM-2310-2 have been superseded by FINRA Rule 2111, effective July 9, 2012. *See Regulatory Notice 11-25*, 2011 FINRA LEXIS 45, at *2-4 (May 2011). A violation of FINRA's suitability rule also violates FINRA Rule 2010. *See Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at *26 (May 27, 2011).

[30] As he did in the context of fraud, the bulk of McGee's appellate arguments concerning customer-specific and reasonable basis suitability focus on whether he recommended that CF surrender the variable annuities and purchase the 54Freedom charitable gift annuity. We have dispensed with this issue in Part III.A.1.a.i. (Duty to Speak), finding that McGee made the requisite "recommendation" for purposes of FINRA's antifraud and suitability rules.

1. Customer-Specific Suitability

Customer-specific suitability requires that a "recommendation be consistent with the customer's best interests and financial situation." *Dep't of Enforcement v. Siegel*, Complaint No. C05020055, 2007 NASD Discip. LEXIS 20, at *37 (NASD NAC May 11, 2007), *aff'd*, Exchange Act Release No. 58737, 2008 SEC LEXIS 2459 (Oct. 6, 2008), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. 2010). McGee asserts that he did not violate customer-specific suitability because CF was a "sophisticated and experienced [money] manager" for whom the surrender of the variable annuities and purchase of the charitable gift annuity was appropriate. McGee's arguments are contrary to the evidence in the record.

The recommended transaction was not suitable for CF in light of her net worth, investment objectives, financial sophistication, and the substantial surrender fees that she incurred as a result of the transactions. When McGee recommended that CF surrender the Hartford and Pacific Life variable annuities and purchase the 54Freedom charitable gift annuity CF was a 71-year-old retiree, with a monthly income of approximately $1,000, who would need to rely on her retirement savings to sustain her for the remainder of her life. She relied on McGee for the management of her investment portfolio, and, over the four years that McGee serviced CF's account, he became familiar with CF, her investment objectives, risk tolerance, and lack of financial sophistication. Indeed, during the hearing, McGee testified that CF was "frugal" and "very nervous about taxes."

Despite this familiarity, McGee recommended that CF surrender 59 percent of her net worth and invest the entirety of the proceeds with a single company – 54Freedom.[31] He also implemented this investment strategy, knowing that CF's sale of the variable annuities would result in surrender fees of more than $36,000.[32] McGee's recommendation of the surrender of the variable annuities, and purchase of the 54Freedom charitable gift annuity, was wholly at odds with CF's stated investment objective ("long term growth") and risk tolerance ("moderate"). McGee's recommendation did not meet the standards for customer-specific suitability. *See Dane S. Faber*, 57 S.E.C. 297, 310 (2004) ("A recommendation is not suitable merely because the customer acquiesces in the recommendation.").

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[31] The value of the four variable annuities was $492,640, or 59 percent, of CF's total net worth of $842,000. But McGee did not manage all of CF's funds. CF maintained $258,000 in a TIAA account, which was not under McGee's management. The four variable annuities constituted 84 percent of the $584,000 that McGee managed.

[32] CF incurred surrender fees totaling $36,202.50. This amount represented more than seven percent of the total value of CF's variable annuities, which had been purchased a few years, and, in one instance, a few months, earlier. CF had held variable annuities for periods ranging from nine to 41 months.

2. Reasonable Basis Suitability

In contrast to customer-specific suitability, the reasonable basis test "relates only to the particular recommendation, rather than to any particular customer." *Siegel*, 2007 NASD Discip. LEXIS 20, at *37 (quoting F. *J. Kaufman and Co.*, 50 S.E.C. 164, 168 (1989)). A registered representative's "recommendation may lack 'reasonable basis' suitability if the broker . . . fails to understand the transaction, which can result from, among other things, a failure to conduct a reasonable investigation concerning the security." *Id.* at *38. McGee argues that the transaction did not lack reasonable basis suitability because he conducted due diligence on Griffin and 54Freedom. McGee lists his due diligence:

> [He] researched and reviewed 54F[reedom]'s website; . . . reviewed marketing materials from 54F[reedom]; . . . talked to people in Cazenovia[, New York,] and determined that [] Griffin had a great reputation in the community; . . . met with [] Griffin and other members of 54F[reedom]; . . . talked to [] Griffin on a number of occasions prior to March of 2011[] and knew him since approximately 2008; . . . learned that [] Griffin ran state of the county presentations in his office; . . .[] was aware that [54Freedom] did a seminar series with the [Internal Revenue Service]; . . . [] was knowledgeable of 54F[reedom]'s offices including an office that was approximately 15,000 square feet; . . . [] visited 54F[reedom]'s call center in Florida; [and learned that] 54F[reedom] was the "hub of Cazenovia[, New York]" back in 2011.

We acknowledge McGee's activities. But these activities are insufficient to satisfy the due diligence requirements of reasonable basis suitability. By McGee's own estimation, his due diligence was limited to reviewing the company's website and marketing materials, visiting the company's call center and office, and having social engagements with Griffin and others in the Cazenovia, New York, area.[33] McGee knew virtually nothing about charitable gift annuities, 54Freedom, or 54Freedom's charitable gift annuity program. McGee knew nothing about 54Freedom's financial condition, nor did he perform any due diligence on their operations. Indeed, he did not know if anyone else actually had purchased a 54Freedom charitable gift annuity. McGee failed to conduct sufficient due diligence on charitable gift annuities, 54Freedom, and 54Freedom's charitable gift annuity program to recommend that CF surrender her variable annuities and purchase a 54Freedom charitable gift annuity. Consequently, McGee's recommendation lacked customer-specific and reasonable basis suitability, in violation of NASD Rule 2310, NASD IM 2310-2, and FINRA Rule 2010.

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[33] During Cadaret Grant's internal investigation, Cadaret Grant's chief compliance officer asked McGee, "[W]hat did you do to investigate and check out 54Freedom[,] and the people involved in it[,] besides playing golf and drinking beers?" Cadaret Grant's chief compliance officer testified that she "didn't get a good response" to that question.

C. McGee Engaged in Undisclosed Outside Business Activities

The Hearing Panel found that McGee violated FINRA Rules 3270 and 2010 because he failed to inform Cadaret Grant in writing of the full extent of his business relationship with 54Freedom. We affirm the Hearing Panel's findings.

FINRA Rule 3270 prohibits registered persons from engaging in any outside business activity unless the registered person has provided written notice to the firm.[34] The rule states, "[n]o registered person may be an employee, independent contractor, sole proprietor, officer, director or partner of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member." FINRA Rule 3270 "ensure[s] that firms 'receive prompt notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities could be raised at a meaningful time and so that appropriate supervision could be exercised as necessary under applicable law.'" *Dep't of Enforcement v. Houston*, Complaint No. 2006005318801, 2013 FINRA Discip. LEXIS 3, at *33 (FINRA NAC Feb. 22, 2013) (quoting *Proposed Rule Change by NASD Relating to Outside Business Activities of Associated Persons*, Exchange Act Release No. 26063, 1988 SEC LEXIS 1841, at *3 (Sept. 6, 1988)), *aff'd*, Exchange Act Release No. 71589, 2014 SEC LEXIS 614 (Feb. 20, 2014).

McGee informed Cadaret Grant that he acted as an independent insurance agent when he joined the firm in April 2007. McGee, however, did not disclose his business relationship with 54Freedom to Cadaret Grant until August 2012, when the firm received the letter from CF's attorney. On appeal, McGee asserts that no disclosures concerning 54Freedom were necessary because 54Freedom was an insurance company and he received all compensation from 54Freedom in his capacity as an insurance agent, and, to the extent disclosures were necessary, his initial disclosures to the firm were sufficient. McGee's arguments demonstrate a profound misunderstanding of FINRA Rule 3270.

FINRA Rule 3270 covers an array of non-securities-related activities, transactions, and relationships that take place outside of the registered person's employment with the member firm. *See Harry Friedman*, Exchange Act Release No. 64486, 2011 SEC LEXIS 1699, at *20 (May 13, 2011) (explaining that, "[NASD] Rule 3030 [the predecessor to FINRA Rule 3270] applies only to transactions involving non-securities products") (citing *NASD Notice to Members 01-79*, 2001 NASD LEXIS 85, at *2-3 (Dec. 2001)). Consequently, McGee's labeling of 54Freedom as an insurance company, himself as an insurance agent, and his compensation from 54Freedom as insurance commissions is irrelevant. The relevant inquiry before us is whether McGee provided Cadaret Grant with written notice of his business relationship with 54Freedom. He did not.

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[34] A violation of FINRA Rule 3270 constitutes a violation of FINRA Rule 2010. *See Dep't of Enforcement v. Moore*, Complaint No. 2008015105601, 2012 FINRA Discip. LEXIS 45, at *25 (FINRA NAC July 26, 2012).

McGee's relationship with 54Freedom was not limited to networking and referrals, as McGee claims. McGee, Griffin, and 54Freedom were business partners. McGee accepted rent-free office space from 54Freedom,[35] began forming a joint venture with Griffin and 54Freedom, and received compensation from 54Freedom for selling the company's charitable gift annuity to CF. The narrow disclosure that McGee provided to Cadaret Grant when he joined the firm was insufficient to notify the firm of his extensive and ongoing business relationship with 54Freedom. McGee's business relationship with Griffin and 54Freedom was outside the scope of his employment with Cadaret Grant, and his failure to disclose the relationship to Cadaret Grant violated FINRA Rules 3270 and 2010.

D. McGee Failed to Timely Update His Form U4 to Disclose His Move to 54Freedom's Offices

The Hearing Panel found that McGee violated Section 2(c) of Article V of FINRA's By-Laws and FINRA Rules 1122 and 2010 because he failed to timely update his Form U4 to reflect moving his business operations to 54Freedom's premises. We affirm the Hearing Panel's findings.

Section 2(c) of Article V of FINRA's By-Laws states that every application for registration, including the Form U4, must be kept current at all times by filing supplementary amendments within 30 days of learning of the facts or circumstances giving rise to the amendment. FINRA Rule 1122 underscores the requirements of Section 2(c) of Article V of FINRA's By-Laws and states, "[n]o member or person associated with a member shall file with FINRA information with respect to membership or registration which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or fail to correct such filing after notice thereof." The duty to provide accurate information and amend the Form U4 to provide current information assures that "regulatory organizations, employers, and members of the public have all material, current information about the securities professional with whom they are dealing." *Richard A. Neaton*, Exchange Act Release No. 65598, 2011 SEC LEXIS 3719, at *17-19 (Oct. 20, 2011). McGee's failure to timely update his Form U4 to update the change in his business address violated FINRA's rules.

It is undisputed that McGee did not update his business address on the Form U4 until December 5, 2011. McGee, however, argues on appeal that he moved to 54Freedom's premises in late 2011 or early 2012, and, accordingly, he asserts that his Form U4 update was timely. McGee's own statements contradict this argument.

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[35] Each party has provided briefing on how McGee's rent-free use of 54Freedom's premises should factor into our outside business activity analysis. McGee's use of 54Freedom's premises informs our analysis only to the extent that it speaks to the nature and depth of the business relationship between McGee and Griffin and 54Freedom. We decline to consider whether McGee's rent-free use of 54Freedom's premises should constitute "compensation" for purposes FINRA's outside business activities rule.

McGee provided on-the-record testimony to the Commission in 2012 and to FINRA in 2012 and 2013. During each interview, McGee stated that he moved to 54Freedom's premises in late 2010 or early 2011,[36] and that he was operating his business from 54Freedom's premises when the events with CF transpired in March 2011. McGee's assistant, Baker, provided a similar late 2010 or early 2011 timeframe for the move when he testified at his on-the-record testimony. The Hearing Panel therefore concluded that McGee was not credible when he testified at the hearing that the move occurred in late 2011 or early 2012.[37] McGee has not provided any evidence to overturn the Hearing Panel's credibility determination on appeal. *Cf. Davidofsky*, 2013 FINRA Discip. LEXIS 7, at *22 (explaining that the fact-finder's credibility determinations are entitled to deference). McGee's belated attempt to revise the date of his move to 54Freedom's address to comport with the notice that he provided to FINRA and Cadaret Grant is not persuasive. McGee failed to timely update his Form U4 to inform FINRA and Cadaret Grant that he moved his business offices to 54Freedom's premises, and, in so doing, McGee violated Section 2(c) of Article V of FINRA's By-Laws and FINRA Rules 1122 and 2010.

E. McGee Provided False Responses on Cadaret Grant's Annual Compliance Questionnaires

The Hearing Panel found that McGee violated NASD Rule 2110 and FINRA Rule 2010 because he made false statements on Cadaret Grant's compliance questionnaires. Specifically, the Hearing Panel found that McGee failed to disclose all of his business-related email addresses on the questionnaires that he completed between 2007 and 2011. The Hearing Panel also found that McGee misrepresented on the firm's 2011 questionnaire that he had not been involved in the offer or sale of any non-Cadaret Grant-processed security or investment without the firm's approval. We affirm the Hearing Panel's findings.

FINRA Rule 2010 and its predecessor, NASD Rule 2110, are FINRA's ethical standards rules.[38] These rules require that associated persons observe high standards of commercial honor and just and equitable principles of trade. NASD Rule 2110 and FINRA Rule 2010 apply broadly to all business-related misconduct, regardless of whether the misconduct involves securities. *See Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996). The principal consideration of NASD Rule 2110 and FINRA Rule 2010 is whether the misconduct "reflects on the associated person's ability to comply with the regulatory requirements of the securities business." *Daniel*

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[36] When McGee provided his on-the-record testimony to FINRA in 2013, he explained that the move occurred in late 2011 or early 2012, then later during that same testimony, he testified that the move occurred in late 2010 or early 2011.

[37] At the hearing, McGee and Baker attempted to disavow their on-the-record testimony, arguing that they provided incorrect moving dates. The Hearing Panel credited McGee's and Baker's on-the-record testimony as temporally closer to the events that occurred, and, therefore, more reliable. We agree.

[38] FINRA Rule 2010 superseded NASD Rule 2110, effective December 15, 2008. *See Regulatory Notice 08-57*, 2008 FINRA LEXIS 50, at *32-33 (Oct. 2008).

D. Manoff, 55 S.E.C. 1155, 1162 (2002). A registered representative's failure to disclose material information to his firm violates NASD Rule 2110 and FINRA Rule 2010 and is misconduct that calls into question the registered representative's "ability to comply with regulatory requirements necessary for the proper functioning of the securities industry and the protection of the public." *Dep't of Enforcement v. Davenport*, Complaint No. C05010017, 2003 NASD Discip. LEXIS 4, at *9-10 (NASD NAC May 7, 2003).

While McGee was associated with Cadaret Grant, the firm required its registered representatives to complete annual compliance questionnaires. McGee completed five questionnaires between 2007 and 2011, one for each year. In each of the questionnaires, McGee certified that he had disclosed all of his business-related email addresses. McGee also certified that he had not been involved in the offer or sale of any type of security or investment that was not "processed through Cadaret Grant . . . without written permission from Cadaret Grant."

Enforcement argues that McGee's responses to these questions were false because McGee failed to disclose a web-based email account that he used to conduct business, and he failed to inform Cadaret Grant of his sale of an outside, unapproved investment (the charitable gift annuity that he sold to CF in March 2011). McGee, on the other hand, asserts that his responses were accurate. McGee states that he was not obligated to disclose the web-based email account to Cadaret Grant because he utilized the web-based email account only for insurance business, and that he was not involved in the offer or sale of any outside, unapproved security or investment because CF's charitable gift annuity did not fall within the spectrum of products that the question covered. McGee's arguments miss the mark.

Although we agree with McGee's reading of Cadaret Grant's email disclosure policy, i.e., that Cadaret Grant only required the disclosure of accounts used for securities, not insurance, business,[39] Baker discredited McGee's statements concerning his business-related email use. Baker testified that he and McGee considered Cadaret Grant's email server slow, and they typically communicated with each other using web-based email accounts, including the web-based email account that McGee failed to disclose to Cadaret Grant in this instance. Baker also testified that the communications from McGee's undisclosed web-based email account were not limited to insurance matters, as McGee claims, but they included securities business, such as communications with Griffin concerning CF, her 54Freedom account, and the charitable gift annuity that she had purchased from 54Freedom.

McGee's response concerning the offer or sale of any outside, unapproved security or investment is similarly false. McGee sold the 54Freedom charitable gift annuity to CF on March 9, 2011. He completed Cadaret Grant's 2011 compliance questionnaire on July 1, 2011. Despite his sale of the charitable gift annuity to CF four months earlier, McGee falsely stated on the questionnaire that he had not been involved in the offer or sale of any security or investment that was not processed through Cadaret Grant without written permission from Cadaret Grant.

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[39] Cadaret Grant's chief compliance officer testified that the firm required its registered representatives to disclose email addresses for securities business, but not for insurance business.

McGee misrepresented on five questionnaires that he had disclosed all of his business-related email addresses and misrepresented on one questionnaire that he had not engaged in any non-Cadaret Grant-processed security or investment without the firm's approval. Based on these facts, we conclude that McGee violated NASD Rule 2110 and FINRA Rule 2010. *See Dep't of Enforcement v. Mullins*, Complaint Nos. 20070094345, 20070111775, 2011 FINRA Discip. LEXIS 61, at *29-38 (FINRA NAC Feb. 24, 2011) (finding that respondents' misstatements on the firm's compliance questionnaires violated FINRA's rules), *aff'd*, Exchange Act Release No. 66373, 2012 SEC LEXIS 464, at *1 (Feb. 10, 2012).

IV. Sanctions

The Hearing Panel barred McGee for the fraudulent omission and unsuitable recommendation, ordered him to pay $236,202.50 in restitution to CF, and ordered him to pay $59,264 in disgorgement. In light of the bar imposed for the fraud and suitability violations, the Hearing Panel assessed, but declined to impose, additional sanctions for McGee's other misconduct.[40] As discussed in detail below, we affirm most, but not all, of the Hearing Panel's sanctions.

A. Fraudulent Omission of Material Fact and Unsuitable Recommendation

McGee's intentional omission of a material fact and unsuitable recommendation are related violations. It therefore follows that any sanction we may impose would be designed and tailored to deter the same underlying misconduct. Accordingly, we, like the Hearing Panel, have decided to impose a unitary sanction for these two violations.

For cases such as this one, which involve intentional or reckless material omissions of fact, FINRA's Sanction Guidelines ("Guidelines") recommend that adjudicators strongly consider barring an individual.[41] The Guidelines also recommend that adjudicators consult the Principal Considerations to determine whether to impose a suspension or a bar, and, if an adjudicator decides to impose a suspension, the Guidelines suggest that adjudicators apply the

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[40] The Hearing Panel explained that it would have suspended McGee in all capacities for one year and fined him $25,000 for engaging in undisclosed outside business activities, suspended him in all capacities for 15 business days and fined him $15,000 for failing to timely update his Form U4, and suspended him in all capacities for 30 business days and fined him $10,000 for providing false responses on Cadaret Grant's annual compliance questionnaires.

[41] In assessing the appropriate sanctions for McGee's misconduct, we consulted the Guidelines. *See FINRA Sanction Guidelines* 88 (2015) (Fraud, Misrepresentations or Material Omissions of Fact), http://www.finra.org/sites/default/ files/Sanctions_Guidelines.pdf [hereinafter *Guidelines*]. We applied the applicable Guidelines in place at the time of this decision and examined the specific Guidelines related to each violation. *See id.* at 8. We also consulted the General Principles Applicable to All Sanction Determinations and Principal Considerations in Determining Sanctions, which adjudicators consult in every disciplinary case. *See id.* at 2-7.

Principal Considerations to determine the length of the suspension.[42] Finally, the Guidelines suggest that adjudicators consider imposing a fine of $10,000 to $146,000.[43]

For cases involving unsuitable recommendations, the Guidelines advise adjudicators to consider a fine of $2,500 to $110,000 and a suspension of the individual in any or all capacities for a period of 10 business days to two years.[44] Where aggravating factors predominate, however, the Guidelines recommend that adjudicators strongly consider barring the individual.[45]

Aggravating factors predominate regarding McGee's fraudulent omission and unsuitable recommendation. McGee convinced his 71-year-old, financially unsophisticated,[46] customer, CF, to sell assets composing more than half her net worth and invest those assets with Griffin and 54Freedom, an individual and company McGee barely knew. CF had been married for 36 years from the age of 20, did almost no work outside of the home, did not have any investment experience, and was not in charge of her family's finances. Yet, McGee selected CF as a "test case" to see if 54Freedom's charitable gift annuity program actually worked. It was, unfortunately, a spectacular failure. CF incurred $36,202.50 in surrender charges. And of the $454,998.75 that CF invested with 54Freedom, CF still has not recouped $200,000 of her original investment.[47] By contrast, McGee's sale of the 54Freedom charitable gift annuity to CF earned him commissions of $59,264, one of the larger commissions of his career, and it furthered his deepening business relationship with Griffin and 54Freedom.[48]

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42 *See id.* at 88.

43 *See id.*

44 *See id.* at 94 (Suitability – Unsuitable Recommendations).

45 *See id.*

46 *See id.* at 7 (Principal Considerations in Determining Sanctions, No. 19) (considering the sophistication of the affected customer). On appeal, McGee asserts that CF was a sophisticated customer with significant financial management experience, and, consequently, there was no need for him to disclose his compensation to her. McGee's argument is faulty. As an initial matter, McGee has provided no evidence to support his unsubstantiated claims concerning CF's financial sophistication. Moreover, we find that the level of CF's financial sophistication has no bearing on McGee's disclosure obligations because there would have been no way for CF to know about McGee's compensation absent his disclosing it to her. *Cf. Dolphin & Bradbury, Inc*., Exchange Act Release No. 54143, 2006 SEC LEXIS 1592, at *36 (July 13, 2006) (stating that, "the protection of the antifraud provisions of the securities laws extends to sophisticated investors as well as those less sophisticated"), *aff'd*, 512 F.3d 634 (D.C. Cir. 2008).

47 *See Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 11) (considering whether the respondent's misconduct resulting in harm to the investing public).

48 *See id.* at 7 (Principal Considerations in Determining Sanctions, No. 17) (considering whether the respondent's misconduct resulted in monetary gain).

The self-serving nature of McGee's fraudulent omission and unsuitable recommendation is striking, and it epitomizes McGee's gross indifference to CF's interests. Even now, McGee unapologetically trivializes the impact of his actions on CF as he explains, "a lot of people in this country have less than $700,000 and they're doing okay."[49] McGee fails to appreciate his obligation to provide CF with full disclosure of his business relationship with 54Freedom and the compensation that he would receive from her purchase of the company's charitable gift annuity. McGee's brazen disregard of CF's interests, the aggravating factors that accompanied his fraudulent omission and unsuitable recommendation, and the absence of mitigating circumstances warrant sanctions at the highest end of the relevant sanction ranges. Accordingly, we bar McGee from associating with any member firm in any capacity.

B. Restitution

The Guidelines instruct adjudicators to order restitution where it is appropriate to remediate misconduct and necessary to "restore the status quo ante where a victim would otherwise unjustly suffer loss."[50] We may order restitution "when an identifiable person . . . has suffered a quantifiable loss proximately caused by a respondent's misconduct."[51] Although the Commission and courts have not adopted a single approach to proximate causation,[52] we conclude that CF's losses were the foreseeable, direct, and proximate result of McGee's misconduct.[53] McGee fraudulently failed to inform CF of his compensation from 54Freedom and failed in his duty to place CF in a suitable investment product. Based on these findings, we order McGee to pay $237,643.25 in restitution to CF.[54] McGee's payment of restitution shall

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49 *See id.* at 6 (Principal Considerations in Determining Sanctions, No. 2) (considering whether the respondent has accepted responsibility for and acknowledged the misconduct).

50 *See id.* at 4 (General Principles Applicable to All Sanction Determinations, No. 5) (discussing restitution).

51 *Id.*

52 *See United States v. Monzel*, 746 F. Supp. 2d 76, 85 (D.D.C. Oct. 22, 2010) ("[T]here is no single approach to proximate causation in either the federal or state courts . . . .").

53 *See Dep't of Enforcement v. Brookstone Secs., Inc.*, Complaint No. 2007011413501, 2015 FINRA Discip. LEXIS 3, *147-53 (FINRA NAC Apr. 16, 2015) (ordering respondents to pay restitution where the customers' losses were the "foreseeable, direct, and proximate result" of the respondents' fraudulent and unsuitable sales of collateralized mortgage obligations).

54 The actual value of the variable annuities that CF surrendered was $492,642. CF paid surrender fees of $36,202.50 and taxes and administrative fees of $1,440.75. She remitted $454,998.75 to 54Freedom. 54Freedom used $254,998 to purchase fixed indexed annuities from Lincoln Financial on behalf of CF, but Lincoln Financial refunded these premiums to CF. The amounts that we have awarded as restitution include the unreturned original investment ($200,000), the surrender fees ($36,202.50), and the tax and administrative fees ($1,440.75),

[Footnote continued on next page]

include interest, which shall accrue from March 9, 2011(the date McGee sold CF the 54Freedom charitable gift annuity), until paid. The interest rate shall be the rate established for the underpayment of income taxes in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a).[55]

C. Undisclosed Outside Business Activities

For engaging in undisclosed outside business activities, the Guidelines recommend a fine of $2,500 to $73,000.[56] The Guidelines also recommend a suspension of up to 30 business days, when the outside business activities do not include aggravating conduct.[57] Where there is aggravating conduct, the Guidelines recommend a suspension of up to one year.[58] In egregious cases, such as those involving a substantial volume of activity or significant injury to a customer, the Guidelines recommend a longer suspension or a bar.[59] In assessing sanctions for cases involving undisclosed outside business activities, the Guidelines advise adjudicators to consider: (1) whether the outside activity involved customers of the firm; (2) whether the outside activity resulted directly or indirectly in injury to customers of the firm; (3) the duration of the outside activity, the number of customers, and the dollar volume of sales; (4) whether the respondent's marketing and sale of the product or service could have created the impression that the firm had approved the product or service; and (5) whether the respondent misled the firm about the existence of the outside activity or otherwise concealed activity from the firm.[60]

Aggravating factors accompany McGee's undisclosed outside business activities. As an initial matter, CF was a customer of Cadaret Grant.[61] Second, there is no evidence in the record

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which CF paid, but did not recoup. The Hearing Panel's restitution award failed to account for the taxes and administrative fees that CF paid.

[55] Although disgorgement would potentially be available here, our review of the evidence suggests that McGee's compensation from 54Freedom was part of CF's investment with the company. We therefore conclude that ordering McGee to pay disgorgement would be duplicative of his obligation to pay restitution.

[56] *See Guidelines*, at 13 (Outside Business Activities).

[57] *See id.*

[58] *See id.*

[59] *See id.*

[60] *See id.*

[61] *See id.* (Principal Considerations in Determining Sanctions, No. 1) (considering whether the outside business activity involved customers of the firm).

to support that McGee distinguished between his employment with Cadaret Grant and 54Freedom when he solicited CF. Consequently, McGee's marketing of 54Freedom's charitable gift annuity to CF could have created the impression that Cadaret Grant had approved of the product.[62] Third, McGee's undisclosed outside business activities with 54Freedom deprived Cadaret Grant of the opportunity to monitor McGee's activities with 54Freedom and insulate CF from the company's dubious products and services.[63] Finally, McGee misled Cadaret Grant about the existence and scope of his activities at 54Freedom on the firm's annual compliance questionnaires and in the investigation that followed CF's complaint to the firm.[64] The presence of these aggravating factors, and the absence of mitigating ones, lead us to conclude that McGee's undisclosed outside business activities merit a $25,000 fine and a suspension in all capacities for one year. We, however, decline to impose these sanctions in light of the sanctions that we have imposed for McGee's fraud and unsuitable recommendation.

D. Failure to Timely Update the Form U4

The Guidelines for failing to timely update the Form U4 recommend a fine of $2,500 to $37,000 and a suspension in any or all capacities for five to 30 business days.[65] In egregious cases, such as those involving repeated failures to file, untimely filings or false, inaccurate, or misleading filings, those involving the failure to disclose or timely disclose a statutory disqualification event or customer complaint, or where the failure to disclose or timely disclose delayed the regulatory investigation of terminations for cause, the Guidelines recommend a suspension in any or all capacities for up to two years, or a bar.[66] The principal considerations for determining sanctions for Form U4 violations include: (1) the nature and significance of the information at issue; (2) whether the failure resulted in a statutorily disqualified individual becoming or remaining associated with a firm; and (3) whether the misconduct resulted in harm to a registered person, another member firm, or any other person or entity.[67]

Although we find that there are no particularly salient aggravating factors applicable to McGee's Form U4 violation, we note that a registered representative's obligation to update his business address is a matter of due course. By the time McGee moved his business operations to

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62 *See id.* (Principal Considerations in Determining Sanctions, No. 4) (considering whether the respondent's marketing and sale of the product could have create the impression that the firm had approved the product).

63 *See id.* (Principal Considerations in Determining Sanctions, No. 2) (considering whether the outside business activity resulted in customer harm).

64 *See id.* (Principal Considerations in Determining Sanctions, No. 5) (considering whether the respondent misled the firm about the existence of the outside business activity).

65 *See id.* at 69 (Forms U4/U5 – Late Filing of Forms or Amendments).

66 *See id.* at 70.

67 *See id.* at 69.

54Freedom's premises in December 2010, he was a seasoned securities professional. McGee had 22 years of industry experience, had associated with several firms, and was a registered general securities principal subject to a heightened level of licensing. In our estimation, McGee knew that he should have updated his Form U4 within 30 days to reflect his new business address.[68] Based on these facts, we conclude that McGee's Form U4 violation merits a $15,000 fine and a suspension in all capacities for 15 business days. We, however, decline to impose these sanctions in light of the sanctions that we have imposed for McGee's fraud and unsuitable recommendation.

E. Misrepresentations on Cadaret Grant's Annual Compliance Questionnaires

There are no specific Guidelines concerning misstatements on firm compliance questionnaires. Nevertheless, the Guidelines related to recordkeeping and the falsification of records are sufficiently analogous under the circumstances because McGee's failure to disclose all of his business-related email addresses and outside securities and investment activities resulted in the falsification of Cadaret Grant's books and records.[69]

For recordkeeping violations, the Guidelines recommend a fine between $1,000 and $15,000 and a suspension in any or all capacities for up to 30 business days.[70] In cases involving egregious recordkeeping violations, the Guidelines recommend a fine of $10,000 to $146,000 and a lengthier suspension of up to two years or a bar.[71] When assessing sanctions, the Guidelines for recordkeeping violations advise adjudicators to consider the nature and materiality of the inaccurate or missing information.[72]

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68 *Cf. Philippe N. Keyes*, Exchange Act Release No. 54723, 2006 SEC LEXIS 2631, at *21 (Nov. 8, 2006) (considering registered representative's 15 years of securities industry experience to determine that it was implausible for him to be unaware of FINRA's prohibition on selling away).

69 *See Guidelines*, at 1 (Overview) ("For violations that are not addressed specifically, [a]djudicators are encouraged to look to the guidelines for analogous violations."); *cf. Mullins*, 2012 SEC LEXIS 464, at *83 (applying the Guidelines for recordkeeping violations for misstatements on firm compliance questionnaires); *Dep't of Enforcement v. Braff*, Complaint No. 2007011937001, 2011 FINRA Discip. LEXIS 15, at *26-27 (FINRA NAC May 13, 2011) (applying the Guidelines related to the falsification of records for false statements on firm compliance questionnaires), *aff'd*, Exchange Act Release No. 66467, 2012 SEC LEXIS 620, at *1 (Feb. 24, 2012). The Hearing Panel also consulted the Guidelines concerning recordkeeping and the falsification of records in its sanctions analysis.

70 *See Guidelines*, at 29 (Recordkeeping Violations).

71 *See id.*

72 *See id.*

For the falsification of records, the Guidelines recommend a fine of $5,000 to $146,000.[73] The Guidelines advise adjudicators to consider suspending the respondent in any or all capacities for up to two years if mitigating factors exist.[74] In egregious cases, the Guidelines suggest that adjudicators consider a bar.[75] When imposing sanctions, the Guidelines instruct adjudicators to consider the nature of the falsified documents and whether the respondent had a good-faith, but mistaken, belief of express or implied authority.[76]

Between 2007 and 2011, McGee misrepresented on five of Cadaret Grant's annual compliance questionnaires that he had disclosed all of his business-related email addresses,[77] and he misrepresented on one questionnaire that he had not engaged in any non-Cadaret Grant-processed security or investment without the firm's approval.[78] Cadaret Grant's compliance questionnaires were important, and McGee's his lack of candor on the questionnaires impeded Cadaret Grant's ability to monitor McGee, his permissible (and impermissible) business operations and activities, and his customer interactions and solicitations.[79] As Cadaret Grant's annual compliance questionnaire stated on the first page, the questionnaires were "an integral part of [Cadaret Grant's] Compliance and Supervision Program," and their "primary objective . . . is to verify [registered representatives'] sales activities and other business activities, as well as their compliance with regulatory requirements and [firm] policies." McGee's misstatements on Cadaret Grant's annual compliance questionnaires reflected "directly on [McGee's] ability to abide by his firm's policies, many of which are designed to protect the public and the firm, and to deal responsibly with the public."[80] Based on these circumstances, we conclude that McGee's misstatements on Cadaret Grant's annual compliance questionnaires merit a $10,000 fine and a suspension in all capacities for 30 business days. We, however, decline to impose these sanctions in light of the sanctions that we have imposed for McGee's fraud and unsuitable recommendation.

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73 *See id.* at 37 (Forgery and/or Falsification of Records).

74 *See id.*

75 *See id.*

76 *See id.*

77 We also note that the undisclosed web-based email address, which McGee used, contained Cadaret Grant's name, and it therefore had the potential to mislead recipients into believing that the firm had authorized emails sent from that web-based email address.

78 *See id.* at 6 (Principal Considerations in Determining Sanctions, Nos. 8, 9) (considering whether the respondent engaged in numerous acts and engaged in the misconduct over an extended period of time).

79 *See id.* at 29, 37 (Principal Considerations in Determining Sanctions, No. 1) (considering the nature of the information missing from the records and the nature of the falsified documents).

80 *Davenport*, 2003 NASD Discip. LEXIS 4, at *10.

V. Conclusion

We affirm the Hearing Panel's findings that McGee: (1) willfully omitted a material fact in connection with a customer's purchase and sale of securities, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010; (2) made unsuitable recommendations to a customer, in violation of NASD Rule 2310, NASD IM- 2310-2, and FINRA Rule 2010; (3) engaged in undisclosed outside business activities, in violation of FINRA Rules 3270 and 2010; (4) willfully failed to timely update his Form U4 to disclose his change of address, in violation of Article V, Section 2(c) of FINRA's By-Laws and FINRA Rules 1122 and 2010; and (5) provided false information to his firm on five annual compliance questionnaires, in violation of NASD Rule 2110 and FINRA Rule 2010.

We bar McGee for willfully omitting a material fact in connection with a customer's purchase and sale of securities and making an unsuitable recommendation to that customer. In light of the bar for those two causes of action, we decline to impose sanctions on McGee for engaging in undisclosed outside business activities, willfully failing to timely update his Form U4, and providing false information to his firm on the compliance questionnaires. We also order McGee to pay $237,643.25, plus interest, in restitution to CF. Finally, we affirm the Hearing Panel's order that McGee pay hearing costs of $12,325.34, and we impose appeal costs of $1,743.04.[81]

On behalf of the National Adjudicatory Council,

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Marcia E. Asquith,
Senior Vice President and Corporate Secretary

[81] The bar is effective as of the date of this decision.