

BEFORE THE DIRECTOR OF THE DEPARTMENT OF FINANCE
OF THE STATE OF IDAHO

STATE OF IDAHO, DEPARTMENT OF
FINANCE, SECURITIES BUREAU,

Case No.: No. 2003-7-01

Complainant,

AGREEMENT AND ORDER

vs.

MCDONALD INVESTMENTS, INC.

Respondent.

The Director of the Department of Finance, State of Idaho (Director) has investigated the activities of Respondent McDonald Investments, Inc. (Respondent). Pursuant to said investigation, it appears that violations of the Idaho Securities Act (the Act), Idaho Code §30-1401, *et seq.*, and NASD Conduct Rules have occurred. The Director and Respondent have agreed to resolve this matter without a public hearing. Therefore, the Director deems it appropriate and in the public interest that this Agreement and Order be entered.

BACKGROUND

1. Respondent has been an Idaho registered broker-dealer since August 3, 1984. Respondent has been a NASD registered broker-dealer since May 15, 1944.
2. On October 15-24, 2001, the Complainant conducted an examination of Respondent's branch office located at 702 W. Idaho, Boise Idaho staffed by Mr. Ray Moore.

FINDINGS

3. During the course of the examination, examiners representing the Complainant found several areas of concern. These concerns were noted in correspondence from the Complainant to the Respondent dated February 11, 2002 and May 17, 2002.

4. Complainant found that many of the client suitability information cards were incomplete and not readily accessible to representatives as a current, accurate resource to determine client suitability. Respondent claims that the cards reviewed by Complainant were not the "official" client suitability records. Respondent claims that the "official" records are held at the New Accounts office in Cleveland, Ohio. NASD Conduct Rule 2310 and Rule 118 of the Idaho Securities Act require that there are reasonable grounds for believing that a recommendation is suitable for a customer. It appears that Respondent's representatives were not able to adequately determine the suitability of recommendations to their clients since complete information is kept at a remote location. Also, Rule 119.03 of the Idaho Securities Act and Rule 3010(b) of the NASD Conduct Rules require that each member establish, maintain, and enforce written supervisory procedures designed to achieve compliance with the applicable securities laws. As evidenced above, Respondent has failed to enforce its written procedures with regard to client suitability.

5. The Complainant's examination revealed various pre-signed and unsigned client documents. Examiners found, during a random sampling of client files, the following documents were incomplete except for the signature of the client:

- ◆ IRA Withdrawal Statement for client Terence Fitzpatrick.
- ◆ IRA Withdrawal Statement for client Philip A. Leavitt.
- ◆ IRA Distribution Request for client Lucille Westerberg.
- ◆ Automatic Transfer Request Form for client Suzanne Skinner.
- ◆ Electronic Funds Transfer Authorization Form for clients Charles and Dorothea Rosenthal.

In addition, the Active Asset Account form for client June L. Skinner is complete except that the client's signature is missing.

Although Respondent has claimed that several of the above documents are from old Key Brokerage accounts, the potential was present, and remains, that these documents could be completed and used without the clients' consent. This appears to reflect a lack of supervision on the part of management and a failure to follow Respondent's written procedures. This is a violation of NASD Conduct Rule 3010 for failing to follow written procedures and Rule 119.03(a) of the Idaho Securities Act which requires the review and approval by a designated supervisor of the opening of each new customer account. Furthermore, it is a violation of Rule 119.03(b) of the Idaho Securities Act, which requires the frequent examination of all customer accounts to detect and prevent irregularities and abuses within the accounts.

6. Complainant also uncovered during the examination several documents that are lacking a signature indicating that the account was accepted or approved by management. During Complainant's random selection and review of client files, Complainant found numerous IRA Adoption Agreement forms that were not signed by management. This is a violation of NASD Conduct Rule 3110(c)(1)(C) and Rule

119.03(b) of the Idaho Securities Act. Rule 3110(c)(1)(C) specifically requires the broker-dealer to obtain, upon the opening of an account, the signature of the representative and manager accepting the account. It is also a violation of Rule 119.03 of the Idaho Securities Act and NASD Conduct Rule 3010 for a failure to follow written procedures.

7. Complainant found that within the client file of Toni L. Kulik a photocopy was made of Ms. Kulik's original IRA Adoption Agreement (which was lacking client objectives). Ms. Kulik's investment objectives were then added to the agreement and a new copy was made sometime after she signed the document. This is a violation of Rule 3110(c)(1)(C) of the NASD Conduct Rules and Rule 118 (unsuitable recommendations) and 119.03(a) of the Idaho Securities Act. Respondent is also in violation of Rule 119.03 of the Idaho Securities Act and NASD Conduct Rule 3010 for failure to follow written procedures.

8. The Complainant's examination revealed the absence of several switch letters bearing the individual client signature in certain of the branch manager's, Mr. Moore's, customer accounts. Mr. Moore failed to obtain the client's signature for these accounts as required by Respondent's policies. Also, Mr. Moore received a commission for the transactions in question against Respondent's policies and procedures. Respondent is in violation of Rule 119.03(b) and Rule 119.01 of the Idaho Securities Act for failure to adequately supervise representatives.

9. During the Complainant's examination interview with Mr. Moore, and in an email dated September 5, 2000 from William Eastin, it was indicated that Mr. Moore was given the title of branch manager in September 2000. Complainant also discovered

correspondence dated October 31, 2000 in which Mr. Moore signed in the capacity of branch manager. Also, Mr. Moore represented himself as the branch manager in that he signed numerous representative change forms between September 2000 and February 2001. Several back office employees referred to Mr. Moore as the branch manager in several email transmissions during the same time period. However, Mr. Moore did not pass the Series 9 and Series 10 examinations until January 17, 2001 and March 1, 2001 respectively. In other words, Mr. Moore was not qualified to act in the capacity of branch manager until March 1, 2001. Respondent is in violation of NASD Conduct Rule 3010(a)(5)(6) for failure to properly register supervisory personnel and make a reasonable effort to determine that supervisory personnel are qualified. Rule 124 of the Idaho Securities Act provides the Complainant authority to enforce the NASD Conduct Rules.

10. In a letter dated November 12, 2001, Ms. Susan Grandstaff, Compliance Officer for Respondent, indicated that Respondent did not draft a delegation letter showing that Ms. Gladfelder was acting as branch manager of the Boise office. As noted throughout our examination letter, Ms. Gladfelder was routinely approving, in a management capacity, new account documents, switching documents, and order tickets.

According to the McDonald Branch Manager Supervisory Manual, "If the delegation is permanent, the Branch Manager should document the delegation and maintain the documentation in the branch's 'Compliance' file. This should be updated annually."

Respondent is in violation of Rule 119.03 of the Idaho Securities Act and NASD Conduct Rule 3010(b) for failure to enforce written supervisory procedures.

11. The Complainant's examination was, in large part, centered on the activities of the Respondent's former representative, Edward Covey. In general, we found many of the same violations as reflected above, and some additional issues pertaining to the practice of "switching". Items 11 through 17 of this order address matters involving Mr. Covey.

It appears that in a letter dated October 31, 2000 Mr. Moore notified clients from the Twin Falls office that their accounts were reassigned to Mr. Moore since the representative in Twin Falls was resigning from Respondent. This letter also stated that Mr. Covey's assistant, Dawn Ashby, would be available for assistance regarding their accounts. Through this arrangement, and with the knowledge of Mr. Moore, Mr. Covey was able to place trades in these Twin Falls accounts. When a trade was generated, Ms. Ashby would contact the New Accounts Department to have the account temporarily reassigned from Mr. Moore to Mr. Covey. Mr. Moore authorized the New Accounts Department to accept Ms. Ashby's instructions regarding these transactions on November 30, 2000. The actions of Mr. Moore appear to violate the operational procedures set forth on page 54 of Respondent's Procedural Manual. After the transaction was completed, the accounts would be reassigned to Mr. Moore. However, Mr. Moore discovered that the client accounts were not being transferred back to his name. Consequently, Mr. Moore halted this practice, but Mr. Covey continued to circumvent the system by:

- Selling mutual fund positions in various Twin Falls accounts.
- Opening new accounts with his own broker number.
- Transferring cash positions from the old account into the new account.

- Purchasing a different group of funds for his “new” clients.

This scheme was a result of serious lapses in the supervision of Mr. Covey and the failure to follow procedures.

12. Ms. Gladfelder was responsible for the review of these accounts and she failed to verify the account number, reflected on the Private Client Information (PCI) card, from which the funds were being transferred. Mr. Moore indicated during our examination that these account numbers could have been added later by Mr. Covey or his sales assistant. Mr. Moore noted that firm procedure requires the manager to sign the PCI card and then return the card to the sales assistant or representative. Mr. Moore suggested that modifications could have been made to the PCI card without Ms. Gladfelder’s knowledge once it was returned to the representative.

13. In response to an information request by the NASD, Respondent included six representative change letters that appear to be signed by Julie Vraspir (Ms. Gladfelder). The documents are dated either March 14 or 15, 2001, and request a broker change from either Mr. Moore or Larry Oliveira (the Twin Falls representative) to Mr. Covey. A review of the forms shows that Ms. Gladfelder’s signature of approval has been photocopied.

14. The branch manager did not follow Respondent’s procedures regarding the review of daily activity. Specifically, Respondent’s policy states:

“When reviewing either the order tickets or the daily trade blotter, the Branch Manager should look for the following:

- ◆ Sales and subsequent purchases of similar products or securities.”

Our examination revealed that Mr. Moore was responsible for, and carried out the review and approval of the daily trade blotter. However, in the situation involving Mr. Covey, Mr. Moore, as the broker of record, received confirmations on solicited sell transactions for various Twin Falls accounts. Mr. Moore states that he did not question the origin of the orders, and as branch manager, Mr. Moore did not discover the switching of mutual funds out of one account into another account, even after receiving the confirmations.

Specifically, we note that on March 27, 2001, Mr. Moore received notification and approved the trade blotter that his client, Lamar Smith, in a solicited transaction, sold \$43,651 in income and utility funds with a settlement date of March 30, 2001. On March 28, 2001, Moore approved a trade blotter stating that Mr. Covey's client, Lamar Smith purchased \$42,000 in utility funds with a settlement date of March 30, 2001. While the trade blotters were generated a few days apart, the settlement date was the same on both sides of the transaction.

16. Our examination also revealed that management did not effectively monitor switch reports reflecting Mr. Covey's activity. The reports are limited to account numbers and, therefore, do not provide management with a reliable mechanism to monitor switching from one account to another account of the same client. Respondent's policy describes switching and states that a Mutual Fund Switch Report was developed to ensure transactional regulatory compliance. However, Respondent's switch report reflects switching relative to each account (as opposed to each client). The daily Mutual Fund Switch Report only draws on switching done within an account. The Switch Report does not appear to be an effective tool in achieving Respondent's goal of monitoring mutual fund switches for each client.

17. On the March 2001 Branch Managers Exception Report for client Tammy Adams, Ms. Gladfelder (initials indicating Julie Vraspir) appears to have signed the report and noted that the funds had been sold out of one SEP IRA account and the new investment was made in a different account. Had management inquired as to why the funds were being sold out of one account and purchased in another account, management would have determined that Mr. Covey was circumventing Mr. Moore's directions.

Respondent is in violation of Rule 3110 of the NASD Conduct Rules for the development and use of switch reports containing inadequate information to detect abuses. Respondent is also in violation of Rule 118 of the Idaho Securities Act for unsuitable transactions in connection with the above switching activity. Respondent is in violation of Rule 119 of the Idaho Securities Act and Rule 3010 of the NASD Conduct Rules for failure to follow written procedures.

VIOLATIONS

18. Respondent failed to have reasonable grounds to believe that its recommendations to clients were suitable. This is a violation of Rule 118 of the Idaho Securities Act and Rule 2310 of the NASD Conduct Rules as evidenced above.

19. Respondent is in violation of Rule 119.03(a) of the Idaho Securities Act for the failure to review the opening of each new account as reflected above.

20. Respondent is in violation of Rule 119.03(b) of the Idaho Securities Act for failure to adequately provide supervisory review for transactions in customer accounts as noted above.

21. Respondent failed to obtain the signature of the representative and/or manager accepting the opening of an account. This is in violation of Rule 3010(c)(1)(C) of the NASD Conduct Rules and evidenced above.

22. Respondent is in violation of Rule 3010(a)(5) and (6) of the NASD Conduct Rules for failure to assign an appropriately registered supervisory representative and for failure to use reasonable efforts to determine that supervisory personnel are qualified to carry out their duties.

23. Respondent is in violation of 3010(b) of the NASD Conduct Rules for failure to enforce written supervisory procedures as noted above.

24. Respondent failed to adequately review transactions in customer accounts as reflected above. This is a violation of Rule 3010(d) of the NASD Conduct Rules.

REMEDIES

25. Idaho Code §30-1413(2) authorizes the Director to deny, suspend or revoke the registration of a broker-dealer that has failed to comply with any provision of the Idaho Securities Act or any rule promulgated under the Act, or imposes an administrative penalty not to exceed ten thousand dollars (\$10,000) for each violation.

26. Respondent agrees to review and revise its policies and procedures to ensure future compliance with applicable securities laws. This includes day-to-day supervision to ensure that these policies and procedures are being followed within Respondent's branch offices.

27. Respondent agrees to remit a fine to the Complainant in the amount of \$25,000 within thirty (30) days of the date of this order.

28. Respondent agrees to comply with all provisions of the Idaho Securities Act, and all rules promulgated under the Act, at all time in the future.

DATED this 17th day of October, 2003.

BY: _____

NAME: Robert G. Jones

Title: CEO/McDonald Financial Group

Marilyn T. Chastain

MARILYN T. CHASTAIN
Bureau Chief, Securities Bureau
Department of Finance
State of Idaho

IT IS SO ORDERED This 23rd day of October, 2003.

Gavin M. Gee

GAVIN M. GEE
Director of Finance

