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Texas State Securities Board

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IN THE MATTER OF	§	
THE DEALER REGISTRATION OF	§	**Order No. IC20-CAF-01**
NEXT FINANCIAL GROUP, INC.	§	

TO: Next Financial Group, Inc. (CRD No. 46214)
John T. Unger, General Counsel
2500 Wilcrest Drive, Suite 620
Houston, TX 77042

DISCIPLINARY ORDER

Be it remembered that Next Financial Group, Inc. ("Respondent") appeared before the Securities Commissioner of the State of Texas ("Securities Commissioner") and, solely for the purpose of resolving an investigation by the Texas State Securities Board, consented to the entry of this order ("Order") and the Findings of Fact and the Conclusions of Law contained herein.

OVERVIEW

From January 1, 2014 through December 31, 2018, an agent of Respondent (the "Agent") used a trading strategy that included short-term trading in Class A mutual fund shares. The Agent's use of the strategy resulted in the Agent's customers incurring significant expenses as a result of the high front-end fees of Class A mutual fund shares. Respondent's supervision of the Agent and the Agent's trading in customers' accounts did not include adequate follow-up to investigate or prevent Agent's short-term trading of Class A mutual fund shares in customers' accounts as required by Respondent's written supervisory procedures. To resolve an investigation by the staff of the Texas State Securities Board (the "Staff"), Respondent has agreed to refund $500,000 to customers as well as pay an administrative fine in the amount of $100,000 for Respondent's failure to enforce its written supervisory procedures.

FINDINGS OF FACT

1. Respondent has waived (a) Respondent's right to notice and hearing in this matter; (b) Respondent's right to appear and present evidence in this matter; (c) Respondent's right to appeal this Order; and (d) all other procedural rights granted to the Respondent by The Securities Act, Tex. Rev. Civ. Stat. Ann. arts. 581-1 to 581-45 ("Texas Securities Act"), and the Administrative Procedure Act, Tex. Gov't Code Ann. §§ 2001.001 to 2001.902.

2. On August 17, 1999, Respondent registered with the Securities Commissioner as a dealer. This registration is currently effective.

3. From March 26, 2007 through September 27, 2019, the Agent was registered with the Securities Commissioner as an agent of Respondent.

4. The Agent is not currently registered in any capacity with the Securities Commissioner.

Trading in Mutual Funds

5. During the relevant period of January 2014 through December 2018 (the "Relevant Period"), the Agent recommended a mutual fund trading strategy to certain of his customers.

6. A mutual fund pools money from investors and invests the money in a portfolio of stocks, bonds, and other securities.

7. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund.

8. Additionally, investors may select different classes of shares in which to invest. While each share class holds the same portfolio of securities, each class also has a different expense or cost structure.

9. Class A shares charge a front-end sales "load" taken out of the initial investment that is paid to a dealer as a commission.

10. For example, a mutual fund Class A share with a 5% sales load would reduce the amount of a $10,000 investment to $9,500 invested in the fund, while $500 would be paid to the dealer as the commission.

11. Class C shares do not impose a front-end sales load, so the entire amount invested goes directly to the mutual fund. But Class C shares have higher annual expenses than Class A shares because of an increased marketing or distribution fee, known as a "12b-1" fee.

12. The annual 12b-1 fee for Class C shares is commonly 1%.

13. These varying fees and expenses necessarily affect performance results. The multi-share class structure offers investors—and agents recommending securities to investors—the ability to select a fee and expense structure that is most appropriate for their investment goals.

14. Given the high front-end sales load but lower annual operating expenses, Class A shares are more appropriate if they are held for longer periods of time, generally three to five years, or more.

15. Class C shares are more appropriate for shorter holding periods since there is no front-end load, but annual expenses are higher.

The Agent's Mutual Fund Strategy

16. The Agent stated that he constantly monitored the performance of mutual funds and "made moves as the market dictates."

17. According to the Agent, the technology he employed enabled him to make decisions based on what he was seeing and react all day to real-time market data.

18. To that end, the Agent was recommending an active mutual fund trading strategy to customers with recurring recommendations to buy and then sell shares of certain mutual funds.

19. Often the Agent would recommend customers buy shares in a certain mutual fund only to recommend that customers sell the shares within a few months because the Agent had identified a different fund with less volatility or a fund paying higher dividends.

20. Yet the Agent almost exclusively recommended Class A shares—not Class C shares—to his customers.

21. The effect of using Class A shares meant customers incurred multiple, frequent front-end load charges.

22. For example, on April 22, 2016, the Agent recommended the purchase of Blackrock Natural Resources Trust Fund Class A shares ("MDGRX") in Customer A's account. Customer A was charged a 4% front-end sales load for the purchase of MDGRX.

23. Eighty-four days later, the Agent recommended the sale of MDGRX and the subsequent purchase of Ivy High Income Fund Class A shares (“WHIAX”). Customer A was charged a 5.20% front-end sales load for the purchase of WHIAX.

24. The sales charges totaled $5,423.94 for these transactions.

25. Similar transactions occurred frequently in the account of Customer A.

26. The Agent recommended the purchase of 41 positions in Class A shares in Customer A’s account during the Relevant Period. Twenty-five of these positions were subsequently sold within the first year of purchase. Some were held for as short as three months.

27. This activity was reflected in the accounts of at least 50 Texas customers.

28. As a result, the Agent and Respondent earned approximately $1,000,000.00 in commissions for the purchase of Class A mutual funds in these accounts during the Relevant Period, while some customers incurred significant losses.

Failure to Enforce Supervisory System

29. Respondent’s policies prohibited the practice of “mutual fund switching,” which it defined in its procedures as liquidating holdings of mutual fund shares and using the proceeds to purchase shares of other mutual funds.

30. Short-term trading of Class A mutual fund shares is generally problematic for customers due to the high initial cost or front-end loads which prevent customers from benefiting from the lower annual fees of Class A shares and inhibit a customer’s investment from recovering over time from the original purchase’s load.

31. To detect and prevent this practice, Respondent implemented a heightened review of frequent mutual fund trading by using SunGard customer account surveillance reports.

32. When a report is generated, Respondent’s written supervisory procedures require that a supervising registered principal obtain additional information or an explanation in response to the triggered flag. The initial contact, follow-up, and resolution of the triggered flag are all to be documented and notated on the exception report spreadsheet.

33. During the Relevant Period there were 969 SunGard alerts generated for customers’ accounts managed by the Agent. Of these alerts, 681—or 70%—identified potential mutual fund switches.

34. Yet 108 of these alerts were effectively disregarded altogether by the Agent's supervisor.

35. For example, one alert generated on May 29, 2015, identified a potential mutual fund switch in the account of one of the Agent's customers.

36. The alert was not reviewed by a supervisor until over three weeks later, on June 18, 2015.

37. At that time, a supervisory comment was added: "In reviewing transactions for this account, several A share [mutual fund] trades have posted in a short time frame...Please provide a justification statement regarding why these trades were done and how it benefits the client.

38. However, the Agent never provided a justification. The alert was closed due to age almost three years later, on May 7, 2018.

39. In the 583 instances where the Agent did provide an explanation to the alerts, many alerts were still left unattended for months at a time.

40. For example, an alert identifying a potential mutual fund switch was generated in an account of one of the Agent's customers on October 16, 2017.

41. A supervisory comment was added to the alert that same day which asked the agent to "please explain the mutual fund switch."

42. Seven months later, on May 17, 2018, the Agent responded with his explanation. After which the alert was approved and closed out on the same day.

43. In fact, the only responses by a supervisor to the comments and explanations provided by the Agent were to approve and close out the alerts.

44. The more than 600 alerts relating to mutual fund switches exhibited a clear pattern in the Agent's management of customer accounts.

45. Yet Respondent did not do a meaningful follow-up, such as contacting customers or investigating the impact that the frequent trading of Class A shares was having on customers' accounts.

46. By not reviewing certain triggered flags and not following up on others (relying exclusively on the Agent's comments), Respondent was unable to detect and prevent the short-term mutual fund trading in the accounts of the Agent.

Mitigating Factors

47. Respondent has cooperated extensively with the Staff during its investigation.

48. Respondent received only 10% of the aforementioned $1,000,000.00 of commissions, with the remaining 90% paid out to the Agent pursuant to the terms of his agreement with Respondent.

CONCLUSIONS OF LAW

49. Respondent's inactions with respect to the SunGard alerts generated in the customer accounts of the Agent was a failure to enforce Respondent's supervisory system and was a violation of §115.10 of the Rules and Regulations of the Texas State Securities Board ("Board Rules").

50. Pursuant to Section 14.A(6) of the Texas Securities Act, the aforementioned violation of a Board Rule constitutes a basis for the issuance of an order reprimanding Respondent.

51. Pursuant to Section 23-1 of the Texas Securities Act, the aforementioned violation of a Board Rule constitutes a basis for the assessment of an administrative fine against Respondent.

UNDERTAKING

52. Respondent undertakes and agrees to refund $500,000.00 to Texas customers of the Agent for whom SunGard alerts were generated indicating potential mutual fund switching in the customers' accounts. Respondent further undertakes and agrees to apportion the $500,000.00 referenced herein among those customers pro rata in accordance with the level of mutual fund trading activity in their accounts during the Relevant Period.

53. Respondent further undertakes and agrees to pay this amount to customers within sixty (60) days of the entry of this Order and to provide legal counsel for the Inspections and Compliance Division of the Texas State Securities Board with evidence of such payments within seventy-five (75) days of such entry.

ORDER

1. It is therefore ORDERED that Next Financial Group, Inc. is hereby REPRIMANDED.

2. It is further ORDERED that Next Financial Group, Inc. COMPLY with the terms of the Undertaking contained herein.

3. It is further ORDERED that Next Financial Group, Inc. shall pay an ADMINISTRASTIVE FINE in the amount of one-hundred thousand dollars ($100,000.00) to the general fund of the State of Texas within five (5) business days of the entry of this Order.

SIGNED AND ENTERED BY THE SECURITIES COMMISSIONER this 13th day of February, 2020.

TRAVIS J. ILES
Securities Commissioner

Respondent

NEXT Financial Group, Inc.

By: John T. Unger, General Counsel

Approved as to Form:

Clinton Edgar
Deputy Commissioner

Jack D. Ballard
Ballard & Littlefield, LLP
Attorney for Respondent

with permission

Cristi Ramón Ochoa
Attorney
Inspections and Compliance Division

Respondent:

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